CONTENTS

PERSONAL TAX 3
Avoiding the 50% tax rate *(Lecture P576)* 3
Current scope for tax planning for spouses or civil partners *(Lecture P577)* 6
Changes to the Income Tax credit for foreign dividends 8
HMRC Interpretation of Section 183 of ITA 10
Factsheet—Restricting relief on pension contributions for high earners 12

CAPITAL GAINS TAX 15
Foreign currency bank accounts held by remittance basis users 15
Jefferies and anor v Revenue and Customs Comrs 17

ADMINISTRATION 19
Deadlines for SA individuals and other taxpayers 19
Cooksey and anor v Revenue and Customs Comrs 19
Medical professionals offered Tax Health Plan *(Lecture P580)* 21
Poopalasingham v Revenue and Customs Comrs 23

BUSINESS TAX 24
Capital allowances and business cars *(Lecture B576)* 24
FHLs - what to do now? *(Lecture P578)* 25
Furnished holiday lettings – transitional rules *(Lecture P579)* 27
A Longworth & Sons Ltd v Revenue and Customs Comrs 29
Mutch v Revenue and Customs Comrs 30
Prior Roofing Ltd v Revenue and Customs Comrs 30
Strongwork Construction Ltd v Revenue and Customs Comrs 31

CORPORATION TAX 33
Extracting Profits from a Limited Company – 2010/11 *(Lecture B577)* 33
Debit balances on directors' loan accounts *(Lecture B578)* 41

VALUE ADDED TAX 46
New EU VAT Refund Procedures 46
New International services rules *(Lectures B579 / B580)* 51

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Personal Tax

Avoiding the 50% tax rate

The 50% rate is scheduled to apply from 6 April 2010 to taxable income above £150,000, and is termed the top rate. The 40% rate is still termed the higher rate.

There are several possible ways of avoiding the charge, the extent of which depends on individual circumstances.

Converting income to capital

It may be advantageous to hold investments within a personal company, if the income is not required to be distributed. Corporation tax is at 28% on interest, with net income retained in the company, but if the investment is in property the small companies rate of 21% is available. Look at closing the company down at a later stage and pay CGT at 18%. However, the possibility of an increase in the rate of CGT impacts on the decision, and waiting to see what happens in the 2010 Budget is probably wise.

Watch the notorious anti-avoidance legislation on transactions in securities in Sections 682 to 713 ITA2007. This serves to tax a profit as income where the person has obtained an income tax advantage in respect of the transaction or series of transactions. The exception to this is in Section 685 which applies if Conditions A and B below are both met.

CONDITION A

The transaction is effected (a) for genuine commercial reasons, or (b) in the ordinary course of making or managing investments.

CONDITION B

Enabling income tax advantages to be obtained is not the main object or one of the main objects of the transaction or of any of them.

There is plenty of case law on this anti-avoidance legislation - in particular Snell v HMRC 2007 STC 1279 where the tax advantage can be found to be one of the main objects even though there is another object which is more important and more influential on the taxpayer. Also it is worth noting that once a tax advantage has been obtained the onus is upon the taxpayer to prove that the transaction was carried out for bona fide commercial reasons without the obtaining of a tax advantage being one of its main objects. This is very wide anti-avoidance legislation which has not always been used to its fullest extent by HMRC but that case may mark a change in approach.

However, arguably the case of Ebsworth v HMRC (TC152) may help as it although it was decided for the taxpayer clearly by reference to the particular facts, it was stated that “taking tax advice does not of itself make tax avoidance one of the main objects of the transactions concerned”.

Dave Hartnett, the HMRC permanent secretary of tax, warned that those switching income tax to capital gains through tax schemes will be kept under "very close scrutiny".

If in partnership with surplus profits which do not need to be distributed, look at forming a limited company which becomes a partner. Surplus profits are retained in the company at a tax charge of 21% or 28%. Close company down in due course and pay CGT at 10% or 18%. Consider whether the mere introduction of a corporate partner might invoke the settlements anti-avoidance legislation.

No annual investment allowance for a partnership with a corporate partner.

Avoiding the personal allowance trap

From 6 April 2010 there is a gradual withdrawal of the personal allowance if taxable income exceeds £100,000. This is via a reduction of £1 of allowance for every £2 of excess taxable income.

This makes marginal income tax rates as follows:

Taxable income	Marginal rate
£100,000 to £112,950	60%*
£112,951 to £149,999	40%
£150,000 +	50%

* 62% from 2011/12 if earned income

If taxable income is ordinarily in the 60% marginal band, consider pension contributions to reduce the income to £100,000. This is not caught by the anti-forestalling rules as they only apply where relevant income is at least £130,000, and tax relief at the top rate is still available.

Accelerate income from 2010/11 to 2009/10

This is clearly not always an easy task, given the need to recognise income in accordance with normal accountancy principles. However there is plenty of scope where the client receives dividends from his own company. The effective tax payable by a top-rate taxpaying shareholder is 25% in 2009/10 and 36.1% in 2010/11.

It may be possible to pay substantial dividends in 2009/10 such that the 2010/11 taxable income does not reach the level of £150,000 which is when the 50% tax rate starts.

Changing the accounting date of a sole trader or partnership could be advantageous for a business with increasing profits and whose accounting date is currently near the start of the tax year. Changing the date to 31 March 2010 could result in some of the increased profits being taxed in 2009/10 instead of in 2010/11.

The first change in the accounting date within a period of six years can be made without challenge. Otherwise it can only be made for commercial reasons.

For employees there may be scope for bonuses being brought forward to 2009/10, or salary being paid in advance.

Create an income tax / CGT loss via a general trading partnership

The partnerships are unincorporated bodies and carry on a commercial business. It is a requirement that the individual partners make identifiable contributions to the partnership business. The loss created for tax purposes can be set against income or capital gains. However, sideways loss relief has seemingly been stopped under this type of scheme following the publication of draft legislation applying from 21 October 2009.

Avoid marginal tax rate of 102% from 6/4/11

Assume the following:

Earnings £160,000

Pension contribution £50,000

Salary increase £10,000

Tax and NIC on salary increase = £5,200 (52% with 2% NIC)

Net salary increase £4,800

Because of salary increase, tax relief on pension contribution is at 30% instead of 40% = reduction of £5,000

Net result is loss of £200 on income of £10,000 = effective rate of 102%

Trusts

With the trust tax rate at 50% from 6 April 2010, consider:

- Distributing capital to discretionary beneficiaries
- Not creating any new lifetime trusts, unless asset protection is vital

The dividend trust rate is 42.5%, and ignoring the 10% tax credit this means that the tax payable in respect of dividend income paid out of the trustees' discretion will be:

Max. distribution without additional tax	36.1%
Max. distribution with additional tax	50%
Effective tax rate on dividend with additional tax	50%
Effective tax rate on gross dividend with additional tax	54.12%

This compares unfavourably to a 50% taxpayer receiving a dividend direct, where the tax is 36.1% of the cash dividend (or 42.5% of the gross dividend). The comparisons are as under:

	DIRECT	VIA DISC. TRUST
	£	£
Non taxpayer		
Dividend/distribution	1,000	500
Tax refund	0	500
Net receipt	1,000	1,000
20% taxpayer		
Dividend/distribution	1,000	500
Tax refund	0	300
Net receipt	1,000	800
40% taxpayer		
Dividend/distribution	1,000	500
Tax (liability)/refund	(250)	100
Net receipt	750	600
50% taxpayer		
Dividend/distribution	1,000	500
Tax (liability)/refund	(361.11)	0
Net receipt	638.89	500

Article by Gerry Hart

Lecture P576 (18.53 Minutes)

Current scope for tax planning for spouses or civil partners

There are a number of effective tax planning strategies which can be utilised by a married couple or civil partnership. Some of them are very straightforward, but are no less worthy of implementation just because of that, and most of them will create tax savings each year. The scope for tax saving is potentially greater with the introduction of the 50% tax rate from 6 April 2010.

Transferring property to the spouse paying less income tax

This is effective provided it is an unconditional gift of both the asset and the income arising from it. Otherwise the income is still taxed on the donor as an arrangement which is regarded as a settlement under Section 620 ITTOIA2005. Section 624 then treats the income as assessable on the donor

Section 626 exempts the donor from tax where the gift is an outright gift between spouses or civil partners and the gift carries a right to the whole of the income. Section 626(4).states that a gift is not an outright gift "if there are any circumstances in which the property or related property is payable to the giver; is applicable for the benefit of the giver; or will, or may become, so payable or applicable".

Following the case of Glyn v IRC 30 TC 321, which considered the meaning of "any circumstances" HMRC accept that where the donee spouse is free to do what he or she likes with the property given, any decision to return it to the donor will be a mere voluntary application of the property outside the terms of the settlement itself.

A measure of protection or benefit for the donor, if this is an issue, should be available as under:

- placing funds into an account with joint beneficial ownership can provide a degree of protection by arranging for withdrawal only if the donor is a signatory; the income is then taxed 50:50; HMRC accepts this provided it is a straightforward gift
- converting property from sole into joint ownership is also acceptable provided it is a straightforward gift; the property could be owned 90:10 in favour of the donor but with the income taxed 50:50
- crediting the income from the asset transferred into a joint account; this is not likely to be regarded as taxable on the donor even though receiving some benefit, provided it was not a condition of the gift being made
- using the income from the asset transferred to meet the family's household/ family/ holiday expenses; also likely to be acceptable with the same proviso

For a partnership arrangement between spouses the issues are whether a profit share different from a capital share is an arrangement caught under the settlement anti-avoidance rules; or the share of the business transferred is excessive for the level of actual involvement.

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

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

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

The issuing of the shares and consequential payment of dividends amounted to the use of a corporate structure to provide an income stream to a minor child, and thereby reduce higher rates of tax. That was a typical situation where the taxation of settlors legislation did apply, and this was consistent with the decision in Jones v Garnett (Arctic Systems) where the spouse exemption acted to exclude the settlement provisions which otherwise applied.

The children did not take part in any commercial transaction. What actually happened is that the grandfather of the minors died and a loan was supposedly made by the minors to the company from monies prospectively owned by them from the estate. The shares were then issued to them.

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

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

In Buck v HMRC SpC716, it was hardly surprising in the particular circumstances that a dividend waived by the husband so that his wife could receive an enhanced dividend was an arrangement caught by the anti-avoidance rules. Accordingly the wife's dividend was taxed on her husband.

The particular circumstances were:

- The company had a lack of reserves sufficient to meet the company's obligation in the absence of the waiver.
- The reserves position had to be looked at on each occasion of a dividend waiver.
- There was accordingly an element of bounty under an arrangement that Mr Buck would not have entered into with someone with whom he was dealing at arm's length.
- The Section 660A(6) exclusion for an outright gift to a spouse was not available as (unlike in Arctic Systems) there was no transfer of shares from husband to wife. The latter acquired her 1 share on issue with the remaining 9,999 shares owned by her husband. This shareholding split meant that in the absence of waivers over a two year period the company would have needed reserves of over £300 million to enable it to pay dividends at the same rate on Mr Buck's shares.

CGT for spouses or civil partners

Consider the following:

- Use of two annual exemptions.
- Bed & breakfast possible, with spouse making the repurchase.

Under entrepreneurs' relief, each spouse has its own £1 million lifetime limit of relief. A transaction between them is treated as giving rise to a "no gain or loss" but that does not stop the transaction being a material disposal of a business asset within Section 169I TCGA1992.

The ownership period of the asset by the donee of a gift from a spouse is not related back to that of the donor for entrepreneurs' relief purposes.

There is scope for tax planning using the spouse as there are no special tax rules applying for entrepreneurs' relief. This is subject of course to being able to show that the transaction is genuine.

Illustrations

Mr D owns two business premises which he lets rent free to D Ltd in which he owns all the shares and voting rights. He is looking to sell one of the premises for redevelopment, and then would continue to let the remaining premises to D Ltd which would be sufficient for its purposes.

Ordinarily there would be no entrepreneurs' relief on a disposal of the premises as it is simply an isolated sale of a business asset.

If Mr D transferred (say) a minimum of 10% of his shares in D Ltd to Mrs D at the same time as he sells the premises, the latter sale may well become an associated disposal qualifying him for entrepreneurs' relief.

Mr E is a sole trader who plans to sell a business asset (typically land with development potential) but to carry on the business. Ordinarily there is no entrepreneurs' relief, but he could consider introducing Mrs E as a partner. That is a disposal for CGT purposes (albeit at no gain or loss).The sale of the business asset to a third party is linked to it and is therefore an associated disposal.

Article by Gerry Hart

Lecture P577 (13.31 Minutes)

Changes to the Income Tax credit for foreign dividends

This brief publicises changes that have been made to the scope of the Income Tax credit for individuals in receipt of dividends from foreign companies. The changes take effect from 22 April 2009 for the current tax year and affect shareholders in:

– foreign companies with a holding that is 10% or more of the issued share capital of the company

– foreign companies with a holding that is 10% or more of a specific class of share in the company

– offshore funds

Full details of the changes and how they affect individual taxpayers will be given in the Notes to the Foreign Pages of the Self Assessment Return.

Background

Dividends received by individuals are currently taxed at headline rates of:

– 10% in respect of basic rate taxpayers

– 32.5% in respect of higher rate taxpayers

However, individuals in receipt of dividends from UK resident companies are entitled under current law to a non–payable dividend tax credit. Since 6 April 2008, individuals with shareholdings of less than 10% in foreign companies have also been entitled to a non–payable tax credit provided that the foreign company is not an offshore fund.

The dividend tax credit is equal to one ninth of the amount of the dividend. Because tax is charged on the gross dividend received, including the tax credit, the effective rate of tax on these dividends is reduced to 0% and 25%.

Shareholders in offshore funds

There are two changes being made to the tax treatment of distributions from offshore funds that are companies where an offshore fund is:

– Substantially invested (holds more than 60% of its assets) in interest bearing assets, individuals receiving distributions will be treated for tax purposes as having received interest and not a dividend or other type of distribution. This means that no tax credit will be available and the tax rates applying will be those applying to interest.

– Equity–based, individuals receiving distributions will be entitled to the dividend tax credit irrespective of the size of their holdings or the territory of origin of the fund.

Shareholders in foreign companies with a holding that is 10% or more of the issued share capital of the company

The dividend tax credit is being extended to shareholders in foreign companies with a holding that is 10% or more of the issued share capital of the company, subject to conditions:

– the territory of the dividend–paying company must be a "qualifying territory" (see below)

– the tax credit is not available where the distribution is one of a series of distributions made as part of a tax avoidance scheme, and any dividend–paying company is not resident in a "qualifying territory"

– the company must not be an "excluded company"(see below)

"Qualifying territory"

A "qualifying territory" is defined as the UK and any territory with which the UK has a double taxation treaty with a non–discrimination article.

The Treasury has the power to make regulations adding to the list of territories that qualify even if the double taxation treaty in question does not contain an appropriate non–discrimination article, or to exclude territories even if the treaty in question does contain such an article.

The following are "qualifying territories":

Argentina, Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belarus, Belgium, Morocco, Bolivia, Bosnia–Herzegovina, Botswana, Bulgaria, Canada, Chile, China, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia Reunion, Falkland Islands, Fiji, Finland, France, Gambia, Georgia, Germany, Ghana, Greece, Guyana, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Ivory Coast, Jamaica, Japan, Jordan, Kazakhstan, Kenya, Korea, Kuwait, Latvia, Lesotho, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mauritius, Mexico, Mongolia, Montenegro, Myanmar, Namibia, Netherlands, New Zealand, Nigeria, Norway, Oman, Pakistan, Papua New Guinea, Philippines, Poland, Portugal, Romania, Russian Federation, Serbia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Sudan, Swaziland, Switzerland, Taiwan, Thailand, Trinidad & Tobago, Tunisia, Turkey, Turkmenistan, Uganda, Ukraine, USA, Uzbekistan, Venezuela, Vietnam, Zambia, Zimbabwe

The government has made regulations to exclude from this list companies which are excluded from the benefits of the double taxation agreement with the UK ("excluded companies"). A dividend from an "excluded company" will be treated as a dividend from a "non–qualifying" territory and will not get the tax credit. The "excluded companies" are:

– Barbados – companies established under the International Business Companies Act(s)

– Cyprus – companies entitled to any special tax benefits under various Cyprus enactments

– Jamaica – companies established under enactments relating to International Business Companies and International Finance Companies

– Luxembourg – holding companies established under the Luxembourg 1929 and 1937 Acts

– Malaysia – companies carrying on offshore business activity under the Labuan Offshore Business Activity Act 1990

– Malta – companies entitled to special tax benefits under various enactments.

Shareholders in foreign companies with a holding that is 10% or more of a specific class of share in the company

Since 6 April 2008, an individual with a shareholding of less than 10% of the issued share capital of a foreign company (a "minority shareholder") has been entitled to the tax credit provided that the foreign company is not an offshore fund. Eligibility to the tax credit is not dependent on the source country of the dividend.

From 22 April 2009, there is an important change in the way the 10% test is applied because the definition of "minority shareholder" has been altered. A "minority shareholder" is now defined as a shareholder with less than 10% of a particular class of share in a company. This will have no impact on the vast majority of individuals with foreign shares, but it is possible that some shareholders with, for example, preference shares will no longer qualify as "minority shareholders".

A shareholder who no longer qualifies as a “minority shareholder” will still receive the tax credit if he can meet the “qualifying territory” test explained above.

Foreign tax credit relief

There is no change to foreign tax credit relief in respect of foreign withholding tax. An individual who is eligible to receive both foreign tax credit relief and the dividend tax credit will get the benefit of both, subject to a ceiling equal to liability to UK income tax in respect of the dividend. “Excess credits” are lost; they are not repayable and cannot be offset against liability to income tax elsewhere.

Please note that where foreign tax credit relief is restricted under the terms of the Double Taxation agreement with the UK, the amount allowable is calculated on the amount of the foreign dividend, not the amount of the dividend inclusive of the dividend tax credit.

Worked examples:

A basic rate taxpayer receives a net foreign dividend of 76.5 after 13.5 withholding tax is deducted at source.

The UK dividend tax credit of one ninth of the dividend is calculated on the gross dividend (1/9 x (76.5 + 13.5) = 10).

The amount subject to income tax is the gross dividend plus the dividend tax credit (90 + 10 = 100).

Basic rate taxpayers are subject to the dividend ordinary rate 10% on their grossed up dividend income (100 x 10% = 10).

This taxpayer is entitled to foreign tax credit relief and the UK dividend tax credit (13.5 + 10 = 23.5). The UK tax liability is eliminated but the excess credit cannot be used.

A higher rate taxpayer receives a foreign dividend on the same basis.

The UK dividend tax credit of one ninth of the dividend is calculated on the gross dividend (1/9 x (76.5 + 13.5) = 10).

The amount subject to income tax is the gross dividend plus the dividend tax credit (90 + 10 = 100).

Higher rate taxpayers are subject to the dividend upper rate 32.5% on their grossed up dividend income (100 x 32.5% = 32.5)

Again, the taxpayer is entitled to foreign tax credit relief and the UK dividend tax credit (13.5 + 10 = 23.5). The UK tax liability is reduced to 9 (32.5 – 23.5).

HMRC Brief 76/2009 18 December 2009

HMRC Interpretation of Section 183 of ITA

This Revenue & Customs Brief explains HM Revenue & Customs' (HMRC) interpretation of how section 183 of the Income Tax Act 2007 (ITA) applies to companies where the relevant trade is carried on in partnership or by a limited liability partnership, and the implications for new investment through the Enterprise Investment Scheme (EIS). This Brief was first published as a Technical Note on 9 December 2009 and this revised version corrects a typographical error in the original.

Background

The EIS makes available various tax reliefs to investors who subscribe for shares in a company which meets certain qualifying conditions.

One of the conditions is that the relevant:

- qualifying trade
- preparation work ,or

– research and development

is at no time during the three year period following issue of the shares, carried on by a person other than the issuing company or a qualifying 90% subsidiary of that company.

Interpretation

During recent consideration of the EIS legislation HMRC has revised its view of how the legislation has effect in relation to partnerships. HMRC considers that the relevant legislation at section183 of ITA has the effect of disqualifying a company where the relevant trade, preparation work or research and development, is carried on by the company in partnership or by a limited liability partnership of which the company is a member. This is because where any of these activities are carried on in partnership or by a limited liability partnership; there are persons other than the issuing company or a qualifying 90% subsidiary of that company carrying on the activity.

How HMRC intends to implement this interpretation

HMRC is obliged to apply the legislation correctly and its discretion to waive tax which ought to be collected, or to give relief from tax other than as permitted by statute, is very limited.

HMRC will apply this new interpretation as follows:

– where, on or before 9 December 2009, shares have been issued and the certificate of compliance authorised under the procedure in sections 204–206 of ITA following receipt of an EIS1 has been issued, we will not apply this interpretation, and an investors' ability to claim relief will not be affected by it

– where, by 9 December 2009, shares have not been issued then, irrespective of whether the company has had an advance assurance, we will apply our understanding of the law as set out in this Note. So, if shares are then issued we will not authorise the issue of the certificate of compliance for the shares where the relevant trade, preparation work or research and development, is carried on by the company in partnership or by a limited liability partnership of which the company is a member, and

– where shares have already been issued on or before 9 December 2009 but the issue of the certificate of compliance has not yet been authorised under the procedure in sections 204–206 of ITA, we will authorise its issue only where we have given an advance assurance in accordance with section VCM21010 of HMRC's Venture Capital Manual. This only applies in relation to the particular share issue for which the assurance was sought, and where the request had stated that the relevant trade, preparation work or research and development would be carried on by the company in partnership or by a limited liability partnership of which the company is a member. In those circumstances only, provided a favourable response was issued to the company under section VCM21040 of HMRC's Venture Capital Manual, HMRC will not refuse to authorise the issue of the certificate of compliance solely on the basis that we do not (now) believe that they meet the requirements of section 183 of ITA. The shares and the issuing company must meet all the other requirements of the EIS regime for the relevant period.

HMRC recognises that this change of view may have adverse implications for those who had intended carrying out a trade in partnership. As announced in the Note on venture capital schemes published today on the HMRC website, we intend to consult more generally on how to ensure that the EIS scheme is targeted appropriately at small businesses. As part of that consultation HMRC welcomes comments on the law as it applies to partnerships.

HMRC Brief 77/2009 16 December 2009

Factsheet—Restricting relief on pension contributions for high earners

This HMRC guidance highlights some of the differences between the anti–forestalling rules that have been in force since 22 April 2009 and the proposed restriction of tax relief due to come in from 6 April 2011.

At Budget 2009, the Government announced its intention to bring in new rules for pensions tax relief to apply from 6 April 2011. At the same time, the Government introduced new rules (known as anti– forestalling rules) that apply from 22 April 2009. These anti–forestalling rules are intended to prevent people making substantial additional pension contributions, taking advantage of the full tax relief available, before the changes in 2011 come into force.

At the Pre–Budget Report 2009, a consultation document "Implementing the restriction of pensions tax relief" was published which set out how the restriction of higher rate tax relief will be implemented in 2011.

Also at the Pre–Budget Report the existing anti–forestalling income threshold was reduced from £150,000 to £130,000 with effect from 9 December 2009, although the income definition was unchanged.

This note highlights some of the differences between the anti–forestalling rules that have been in force since 22 April 2009 and the proposed restriction of tax relief due to come in from 6 April 2011.

Anti–forestalling

From 22 April 2009, individuals are subject to the anti–forestalling rules if their "relevant income" is £150,000 or more. From 9 December 2009, this was extended to include individuals with a "relevant income" of £130,000 or more. However, the definition of "relevant income" for the purposes of the anti–forestalling rules has not otherwise changed.

For the purposes of anti–forestalling the definition of "relevant income" is as follows:

– the individual's total taxable income for the year – step 1

– plus any pension contributions they make under net pay (and corresponding relief) – step 2

– less any qualifying losses – step 3

– less their total relievable pension contributions up to a maximum of £20,000 – step 4

– plus any salary sacrifice made to provide pension benefits to the individual during the year agreed since 22 April 2009, or for those with "relevant income" of below £150,000, any salary sacrifice agreed since 9 December 2009 – step 5

– less the amount of any grossed up gift aid donations – step 6

There is also a "look back" test. Those with relevant incomes below the threshold in the tax year will also need to check whether or not their "relevant income" was also below the threshold in both the previous two tax years. If it was on or above the threshold then they will be subject to the anti–forestalling rules for the tax year.

An example of calculating "relevant income" can be found at RPSM15101100.

Other facts about the anti–forestalling rules

Affected individuals have a special annual allowance. This is based on one of the following amounts:

– £20,000 – where no irregular contributions have been paid to (a) money purchase arrangement(s)

– an amount of more than £20,000 but less than £30,000 – where irregular money purchase contributions have been paid and this is the average amount of these contributions over the 3 tax years before 2009–10

– £30,000 – where irregular contributions have been paid to (a) money purchase arrangement(s) and the 3 yearly average of those contributions is £30,000 or more

The section of RPSM starting at RPSM15102000 explains how you calculate an individual's special annual allowance.

Regular ongoing contributions (pension input amounts) are protected.

All contributions above the special annual allowance that are not protected are subject to the special annual allowance charge to restrict relief to basic rate. All contributions less than the special annual allowance or that are protected inputs will receive tax relief at the individual's marginal rate.

There is no taper.

The special annual allowance legislation is in Schedule 35, Finance Act 2009.

2011 Changes

Individuals will be affected by the restriction of tax relief on pension contributions from 6 April 2011 if their "gross income" is £150,000 and over and their "relevant income" is £130,000 and over.

For the purposes of the 2011 changes the definition of "relevant income" is as follows:

– the individual's total taxable income for the year

– plus any pension contributions they make under net pay (and corresponding relief) and any amount paid under payroll giving

– less any qualifying reliefs, but excluding any gifts of qualifying investments to charities

– plus any salary sacrifice made to provide pension benefits to the individual during the year agreed since 22 April 2009.

For the purposes of the 2011 changes the definition of "gross income" is as follows

– the individual's total taxable income for the year

– plus any amount under payroll giving and any pension contributions they make under net pay (and corresponding relief)

– less any qualifying reliefs, but excluding any gifts of qualifying investments to charities

– plus the total pension savings amount of the individual (including employer contributions), excluding any relievable contributions made by or on behalf of the individual.

Other facts about the 2011 changes

There is no special annual allowance.

There are no protected contributions.

Tax relief on pension contributions will be restricted for those with “gross incomes” of £150,000 and over. From that level, the value of pensions tax relief will be tapered down until, for those on “gross incomes” of £180,000 and over it is 20%, making it worth the same as for a basic–rate taxpayer.

HMRC Factsheet 21 December 2009

Capital Gains Tax

Foreign currency bank accounts held by remittance basis users

This note sets out the detail of the proposed changes announced by the Financial Secretary to the Treasury on 16 December, which are to come into effect in relation to remittances on or after that date, to prevent the creation of CGT losses arising in certain circumstances from transactions on foreign currency bank accounts.

Introduction

On 16 December 2009 the Financial Secretary to the Treasury announced in a written statement to Parliament proposed changes to the capital gains tax (CGT) rules where:

- individuals who are not domiciled in the UK and who chose to pay tax on the remittance basis;
- they make a taxable remittance to the UK from a bank account in a currency other than sterling (a "foreign currency bank account"); and
- the remittance comprises or includes an amount that is liable to tax as remitted foreign income, or that is to be taken into account in computing income, or would be taken into account for income tax but for an exemption.

Background

A foreign currency bank account (FCBA) is an asset within the scope of CGT (section 252(1) of the Taxation of Chargeable Gains Act 1992 (TCGA)). A withdrawal of funds from a FCBA constitutes a disposal (or part–disposal) of the account on which a capital gain or loss arises. The consideration for the disposal is effectively equal to the sterling value of the amount withdrawn at the time of withdrawal.

There is an exception for sums in a FCBA which were acquired for personal expenditure outside the UK of the individual and their family (section 252(2) TCGA). Sums acquired for personal expenditure abroad do not give rise to chargeable gains or allowable losses. Such sums are not affected by the proposed changes.

Where:

- a non–domiciled individual is taxable on the remittance basis in respect of their foreign income and capital gains,
- the individual withdraws funds from a FCBA situated outside the UK, and
- the whole or part of the amount withdrawn represents foreign income taxable on the remittance basis,

the foreign income transferred will be liable to income tax at the time of remittance. The amount on which income tax is due is the sterling value of the income at the time it is remitted.

However the withdrawal of funds also represents consideration for disposal of the whole or part of the FCBA for CGT purposes. HMRC now accepts that section 37 TCGA applies in this situation to exclude from the calculation of the capital gain or loss arising on disposal (or part–disposal) of the FCBA the whole of, or the relevant part of, the withdrawal that is taxable as remitted income.

The exclusion of consideration from the capital gains computation under section 37 can produce an anomalous result. By way of illustration, suppose the individual paid salary in foreign currency of FC20,000 into a FCBA abroad at a time when FC1.00 = £0.50. For CGT purposes, the cost of acquiring the FCBA is £10,000. In the next tax year he transfers the whole FC20,000 to the UK at a time when FC1.00 = £0.60, receiving a credit of £12,000 in his UK sterling bank account. For income tax purposes the taxable amount is £12,000 (the value of FC20,000 at the time of remittance).

For CGT purposes the computation is as follows:

Consideration for disposal of the FCBA	£12,000	
Less exclusion under section 37 TCGA	£12,000	nil
Acquisition cost		£10,000
Loss		£10,000

This loss for CGT purposes is excessive, because the individual has incurred no real loss in these circumstances. It arises because the TCGA rules adjust the consideration for the disposal of the FCBA, but there is no requirement to remove the relevant income element from the allowable cost of the FCBA. The loss is an arithmetical anomaly.

Where a remittance comprises only part of the funds in the FCBA, so there is only a part–disposal of the account, a second anomaly arises. The normal rule for apportioning the allowable cost of the asset between the part disposed of and the remainder (the familiar A/(A + B) formula in section 42 TCGA) is distorted by the exclusion of the taxable income from the consideration for the disposal (the A element of the formula). The consequence is that the cost attributable to the remainder under the A/(A + B) formula is greater than the amount that is proportionate to the size of the remainder.

By way of illustration of this second anomaly, where (say) 40% of the FCBA is remitted to the UK and that 40% is wholly taxable as a remittance of income, the consideration for the disposal is reduced by section 37 TCGA to nil, as in the example above. As the A element of the A/(A + B) formula is nil, the result is that the whole of the cost of the account is attributed to the remainder of the account, whereas under a properly proportionate formula only 60% of the total allowable cost should be attributed.

Proposed changes to the TCGA rules

For disposals on or after 16 December 2009, where the disposal is a withdrawal of funds from a FCBA that comprises in whole or in part an amount that is liable to tax as remitted income, the gain or loss arising will be calculated using the following steps:

– Identify the part of the withdrawal that is taxable as remitted income and, accordingly, excluded from the consideration for the disposal by virtue of section 37 TCGA (“the section 37 amount”).

– Then proceed under A or B below, depending on whether the amount remitted is wholly or partially the section 37 amount.

A – Remittance is wholly the section 37 amount

a. Where the section 37 amount is the whole of the balance on the account, so there is a full disposal of the account, the loss arising on the disposal will not be an allowable loss for CGT purposes.

b. Where the section 37 amount is only part of the account, so there is a part– disposal of the account, disapply the normal part–disposal formula in section 42 TCGA.

– Instead, apportion the allowable cost of the account between the part disposed of and the remainder in proportion to the amounts withdrawn and retained, and compute the loss on the part disposed of accordingly (so that section 37 reduces the consideration to Nil but the proportionate cost is deducted).

– The loss arising on the disposal will not be an allowable loss for CGT purposes.

B – Remittance is partially the section 37 amount

a. Treat the disposal as, in effect, two disposals, one comprising the section 37 amount and the other comprising the rest of the remittance.

b. Where the two disposals are of the whole of the balance on the account, so there is altogether a full disposal of the account:

– Apportion the allowable cost of the account between the two disposals in proportion to the sums comprised in each disposal (disregarding the exclusion of the section 37 amount from the consideration for one of the disposals) and compute the gain or loss on each disposal accordingly.

– The loss arising on the disposal related to the section 37 amount will not be an allowable loss for CGT purposes (this is bound to be a loss because the effect of section 37 is to reduce the consideration to Nil but the proportionate cost is deducted).

– The gain or loss arising on the other disposal will be chargeable or allowable in the normal way.

c. Where the two disposals together comprise only part of the account, so that there is a part–disposal of the account:

– Disapply the normal part–disposal formula in section 42 TCGA.

– Instead, apportion the allowable cost of the account between the two disposals and the remainder in proportion to the sums comprised in each disposal (disregarding the exclusion of the section 37 amount from the consideration for one of the disposals) and the balance remaining in the account and compute the gain or loss on each disposal accordingly.

– The loss arising on the disposal related to the section 37 amount will not be an allowable loss for CGT purposes (this is bound to be a loss because the effect of section 37 is to reduce the consideration to Nil but the proportionate cost is deducted).

– The gain or loss arising on the other disposal will be chargeable or allowable in the normal way.

The HMRC note sets out a number of examples to demonstrate how the above rules will work.

Jefferies and anor v Revenue and Customs Comrs

The husband and wife owned a hotel which they used partly as a private residence and partly for their hotel trade. In 2006 they sold the hotel, realising a capital gain of £576,945. The parties agreed that 35% of the hotel should be treated as allocable exclusively to the taxpayers' hotel business and the remaining 65% to their use as a private residence. The husband and wife were entitled to private residence relief ("PRR") from capital gains tax in respect of the element of the hotel which was allocated to their private residence in accordance with TCGA 1992 s 224(1), which amounted to £375,014. After the application of PRR, £201,931 of chargeable gains remained. In their tax returns the husband and wife treated the whole amount as qualifying for business asset taper relief under TCGA 1992 s 2A. HMRC issued amendments on the basis that only 35% (the business allocation) of the £201,931 should be treated as qualifying for business asset taper relief. The husband and wife appealed. The issue arose as to how the taper relief rules contained in TCGA 1992 s 2A and Sch A1 were to be applied in circumstances when relief from capital gains tax had already been partially given under TCGA 1992 s 222, which provided relief from capital gains tax for gains arising on the disposal of a particular asset. HMRC contended that the £201,931 of non-PRR gain should be appointed between business and non-business gains for taper relief purposes on the grounds that (i) the hotel was acquired and disposed of as a single asset; (ii) the chargeable gains arising were the gains accruing on the sale of the hotel minus the PRR; (iii) the chargeable gains arose from the disposal of the whole asset and not just the part used for the couple's business; and (iv) those chargeable gains were subject to taper relief and had to be apportioned into a business and a non-business relief in order to calculate taper relief. The husband and wife submitted that—(i) the unrelieved gain should not be apportioned into business and non-business gains before the application of taper relief as an apportionment between

business and non-business use had already been made for the purposes of PRR; (ii) TCGA 1992 s 224(1), in allocating gains arising from an asset used partly for a business and partly for a non-business purpose attributed those gains to a specific, physical part of the property—as supported by HMRC's guidance in their Capital Gains Tax Manual (CG64663); and (iii) to apply taper relief correctly it was necessary to identify the asset type (business or non-business) associated with the chargeable gain. Here, the chargeable gains on the asset in question were attributable to the business use of the property and therefore the whole of the gain qualified for business asset taper relief.

The tribunal considered that the apportionment under TCGA 1992 s 222 was only an apportionment of gains and not of the underlying capital asset. The section operated, as did the relieving provisions of TCGA 1992 generally, by removing the gain, or part of a gain, from charge, not by removing the asset, or part of the asset from charge. The taper relief legislation in TCGA 1992 s 2A(3) asked not whether the gain for which the relief was sought was a gain arising from an asset (or part of an asset) which was used exclusively for business purposes, but whether it was the gain on the disposal of a business asset. As s 222 had not removed the capital asset, or any part of it from the tax net, only the gains or part of the gains relating to it, and on the basis that the apportionment under s 222 was an apportionment of gains and not of the underlying capital asset, the taper relief rules had to be applied to the whole of the relevant asset, in the instant case, to the whole of the hotel. The legislation did not provide room to argue that since the chargeable gains in point arose only from a proportionate part of the asset, it was only that proportionate part of the asset that could be considered for taper relief purposes. Having identified the underlying asset, TCGA Sch A1, paras 3 and 5 defined what was a business asset for those purposes and para 9 prescribed how the legislation was to be applied when, as in the present case, a business asset was used for different purposes during the relevant holding period (a “mixed use period”). It was necessary to establish the proportion of the business asset which, by reason of non-qualifying use, was to be treated as a non-business asset for the purposes of the taper relief calculation. As the interaction of the taper relief legislation and s 222 as applied by HMRC produced gains from the asset which were outside the scope of both PRR and business asset taper relief, the just and reasonable apportionment—as required under Sch A1, para 9—was to apportion the chargeable gains on the basis that there was no proportion of the use of the asset which was a non-qualifying use. Applying that approach, the whole of the couple's chargeable gain in respect of the asset remaining after the application of PRR should be treated as eligible for business asset taper relief. It followed that the appeal would be allowed.

Appeal allowed.

Tribunal—Rachel Short (Judge) and David Earle (Member), ***29 October 2009***

Administration

Deadlines for SA individuals and other taxpayers

HMRC have published further information about the new standard limit of four years from the end of the tax year for making claims for repayments of tax.

The limit for the department to issue tax assessments (except where a loss of tax has resulted from carelessness or been done deliberately) was also reduced to four years.

The current limit for income tax and capital gains tax is five years from the 31 January immediately following the tax year. So, the current time limit for the 2003/04 tax year is 31 January 2010.

For self-assessment taxpayers, the new time limits take effect from 1 April 2010, while for individuals outside the self-assessment regime, the new time limits take effect from 1 April 2012.

This includes people who pay their income tax on their earnings through PAYE, or people whose income is below the tax threshold.

For individuals who pay tax through both the PAYE and self-assessment systems, the self-assessment deadlines will apply.

The new deadlines applying to self-assessment taxpayers are:

Tax year	**Deadline**
2003/04	31.1.2010
2004/05	31.3.2010
2005/06	5.4.2010
2006/07	5.4.2011
2007/08	5.4.2012
2008/09	5.4.2013

The deadlines applying to other taxpayers are:

Tax year	**Deadline**
2003/04	31.1.2010
2004/05	31.1.2011
2005/06	31.1.2012
2006/07	31.3.2012
2007/08	5.4.2012
2008/09	5.4.2013

Cooksey and anor v Revenue and Customs Comrs

The husband and wife ran a business together. In September 1998 HMRC wrote to the couple's then accountants requesting information about the tax affairs of the couple's two companies and enquiring whether any of the directors had invested money overseas, or dealt with an overseas company or trust. The husband became concerned as for several years he had invested money overseas in offshore accounts; and had withdrawn money using a cheque book. On the advice of his then accountants, he requested HMRC's agreement to make a full disclosure under the Hansard procedure. The Hansard meeting took place on 20 April 1999 and at the outset HMRC confirmed that they were conducting an investigation under Code of Practice 9 (suspected serious

fraud). The Hansard statement given to the husband gave no definite undertaking to refrain from prosecution, even in a case where a full confession had been made. The meeting covered a number of issues relating to the business and personal affairs of the couple and it was agreed that a disclosure report would be prepared on behalf of the couple for consideration by HMRC. However the report made no disclosure in respect of any undeclared sales but it did contain a calculation of tax due of £12,000 in respect of undeclared capital gains tax which the husband paid to HMRC. In September 2002 HMRC issued information notices pursuant to TMA 1970 s 20 requesting information from, inter alia, the couple's bank and accountants. In December 2002 HMRC raised discovery assessments under TMA 1970 s 29 on the husband and wife in respect of the tax years 5 April 1982 to 5 April 2001, having reached the view that—in respect of the years up to 1985-86—there were undeclared sales in their two companies; and in respect of the later years there were undeclared profits from overseas investments and monies extracted from the companies. The amounts assessed prior to 1986-87 were additional trading profits taxable under Case I of Sch D and for the years thereafter were a mix of overseas interest taxable under Case V of Sch D and a benefit in kind (being advances to directors) taxable under Sch E pursuant to TA 1988 s 160 (as it then was). The husband and wife appealed and the following issues arose for consideration: (i) the consequences of there being express or implicit allegations of fraud; and (ii) whether HMRC had made a "discovery" to entitle them to issue assessments pursuant to TMA 1970 s 29. On issue (i) the husband and wife contended that (a) once the Hansard statement had been read the HMRC enquiry took the form of a criminal investigation. It followed that the burden of proof of wrongdoing fell on HMRC and that the appropriate standard of proof was the criminal one of beyond reasonable doubt; (b) the criminal nature of the investigation invoked their rights under art 6 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (as set out in HRA 1998 Sch 1), and in particular the right not to incriminate themselves. They contended that, inter alia, the delivery of the schedule of assets under the Hansard procedure had been induced by the assurance in the Hansard statement that they would not be prosecuted if they disclosed the required information; and that their right to a trial within a reasonable time had also been violated. On issue (ii) they submitted that the s 29 assessments were flawed as (a) HMRC had alleged fraud and therefore had to prove "fraudulent conduct" to satisfy the requirements of TMA 1970 s 36 in relation to the back duty assessments; and (b) for a "discovery" to be made in a case where HMRC had interviewed them under the Hansard procedure and alleged undisclosed profits arising from unreported business transactions, HMRC had to conduct a thorough review of the business prime accounting records and their personal financial records. HMRC submitted (i) they only had to satisfy the tribunal that it was more likely than not that the failure to assess profits to tax was due to the negligent conduct of the taxpayers; they did not have to satisfy the tribunal in relation to fraudulent conduct as that was an alternative to negligent conduct; (ii) the test for them to demonstrate a discovery constituted a low hurdle which was satisfied on the evidence.

The judge considered on the authorities that the taxpayer bore the burden of proof regardless of any express or implicit allegation of fraud. TMA 1970 s 50(6) put upon the taxpayer the burden of proving that he had been overcharged by the assessment. The fact that fraud had been expressly or implicitly alleged did not shift that burden away from the taxpayer onto HMRC. On the facts the husband and wife had failed to discharge the evidential burden on them to disprove the assessments. The husband, who was an unreliable witness, did admit to his first set of accountants that there had been undeclared cash sales for many years; that the proceeds of such sales had been placed in offshore accounts or investments and accrued interest or gains over the years; and that the husband could draw freely on those funds using a chequebook.

As there was authority that the applicable standard of proof in proceedings for direct tax penalties was the civil standard of proof, the judge considered that the civil standard certainly applied to appeals against assessments to income tax; *Revenue and Customs Comrs v Khawaja* [2008] STC 2880 applied.

The judge considered that the couple's rights had not been violated under art 6 of the Convention. Article 6 was not in point in relation to self-incrimination on the facts of the current appeal as there was no question of any confession or self-incrimination. The husband and wife had always denied and continued to deny absolutely that there were any undisclosed cash sales. Furthermore in the particular circumstances of the case the length of the investigation was not so excessive so as to be unreasonable. In addition on the facts the husband and wife had not been denied information as to the nature and cause of the investigation into their tax affairs and the

information was supplied in a reasonable timescale taking into account their continued failure to make disclosure of the matters being investigated by HMRC.

The judge considered it was self-evident that submitting returns which failed to report cash sales or overseas income or gains constituted at least negligent conduct. HMRC did not have to satisfy the tribunal in relation to fraudulent conduct as well.

The judge found on the evidence that HMRC did receive information to give them reason to believe that there was income which ought to have been assessed to income tax which had not been assessed. On the facts there was a discovery for the purposes of TMA 1970 s 29. It followed that the appeals would be dismissed.

Appeals dismissed.

Medical professionals offered Tax Health Plan

On 11 January HMRC announced a new facility called the Tax Health Plan (THP). The plan is very similar to the New Disclosure Opportunity (NDO) and the Offshore Disclosure Facility (ODF) before that. However, rather than focussing on offshore bank accounts, the THP is aimed at medical professionals regardless of their banking preferences.

Key dates are as follows:

- 31 March 2010 – register to make a disclosure
- 30 June 2010 - make a full disclosure
- 6 April 1988 – 5 April 2008, the maximum period the disclosure should cover.

When the THP was first announced it was stated by HMRC as being opened to “all medical professionals”. However, a General Medical Council (GMC) registration number is also requested as part of the details required when notifying an intention to make a disclosure. A lot of medical professionals such as dentists will not normally be associated or registered with the GMC. Despite this, it was widely, and initially incorrectly, reported that the scheme covered dentists as well as doctors. On 15 January HMRC confirmed that the THP is not available to dentists. However, HMRC also confirmed that it had opened discussions with the General Dental Council to see if dentists could be included. In addition, it was announced that HMRC already had plans to provide similar opportunities to other professional groups which may include dentists.

On 18 January, just 3 days later, HMRC announced that it had decided to include dentists in the THP after all! Hence the facility now applies to all GMC registered professionals plus dentists and provides a relatively straightforward opportunity to get their tax affairs in order.

Details of the scheme

HMRC believes that some medical professionals have failed to declare their total profits and commissions, perhaps from insurance sources such as BUPA, on their tax returns. The THP is being offered as an incentive to rectify these irregularities at a relatively low cost and with a fixed penalty of only 10%. Similar to the NDO and ODF HMRC has obtained bulk data from third parties, this time from the likes of NHS trusts and BUPA rather than from banks.

In order to be able to use the NDO there must first be an outstanding tax liability connected to income as a medical professional. Once that has been established the professional can use the THP to disclose all tax irregularities, even those totally unconnected with his business as a medical professional, for example previously undeclared bank interest or rental profits. Unfortunately it does not work the other way round. If the medical professional has undeclared rental income for example, but his professional profits are all in order then the THP cannot be used to declare that rental income. Instead, a separate disclosure should be made to HMRC which could lead to a relatively low penalty under the normal regime given its voluntary nature.

As with previous partial amnesties there are certain people who cannot use the THP even though they are medical professionals. It is not open to:

- Individuals where HMRC has already begun an investigation or enquiry into their affairs.
- Individuals where there is a suspicion of wider criminality such as MTIC fraud.

The Penalty

As with the ODF, NDO and its Liechtenstein cousin the Liechtenstein disclosure facility (LDF), the headline penalty rate is set at flat rate of 10%. However, if the unpaid tax is linked to an offshore account or asset HMRC assumes that the individual knew about the ODF in 2007 or the NDO in 2009/10, hence had an opportunity to use those facilities. The 10% offered under the THP will therefore not be available.

Other Matters

If the tax is unpaid as a result of innocent error then no penalty will be charged. It is, however, down to the individual to convince HMRC that the case is one of innocent error and it is likely that HMRC will require evidence to back this up.

Anyone coming forward under the THP is unlikely to face any further criminal sanctions even if the tax was undeclared deliberately. Whilst HMRC will not guarantee immunity from prosecution, it is considered extremely unlikely if a voluntary disclosure is made. Similarly, HMRC argue that the THP disclosures do not fall within the criteria for Code of Practice 9 (The Civil Investigation Fraud) to be applied. Hence, if Code 9 is being considered, the disclosure should be made outside of the THP and a managed approach made to HMRC.

As with the NDO, HMRC says that individual should make their best estimates of undeclared income if records are incomplete. This is of course always a problem when looking back over such long period (i.e. twenty years). HMRC considers that more recent records should be available and that reasonable estimates should be possible.

Non Disclosure

After 31 March 2010 when the notification period ends HMRC will use the information that it has already obtained from third parties such as the NHS, Private hospitals and medical insurers. HMRC has confirmed that it will also continue to seek new information from third parties and possibly from the tax payer in question. The information obtained will be matched against income previously returned and any miss-matches will be enquired into. If additional taxes are found, penalties are unlikely to be less than 30% and could be as high as a 100%.

Immediate Action

Do not delay. The registration deadline is only a few weeks away and three months after that the scheme closes. Experience shows that three months is not a long time to gather all the data required and prepare the detailed calculations that will be needed before a disclosure pack can be put together for HMRC. All affected individuals should now start gathering their records to establish the undeclared income, profit and gain for each year and consequently calculating the tax, interest and penalty due. There may be National Insurance and VAT to account for as well as income tax. If irregularities are found the THP represents a golden opportunity to rectify matters in a relatively pain free manner, both financially and mentally. If additional expenses are found then these can be claimed if they are valid deductions to be made against the additional income that is being declared.

Finally, medical professionals should not view this as the only opportunity to come forward. Some will have registered under the NDO and will now face a choice of two facilities. Others may be able to use the Liechtenstein facility. Whilst this might involve moving investments to Liechtenstein if

funds are not already held there, the LDF can be extremely beneficial in the right circumstances and should not be discounted even by those who do not already have a Liechtenstein presence.

Lecture P580 (11.16 Minutes)

Poopalasingham v Revenue and Customs Comrs

HMRC opened an enquiry into the appellant's self-assessment tax return for the year ended 5 April 2005 after a routine value added tax (VAT) assurance visit to his business, a take-away restaurant, raised concerns that takings had been suppressed, that there were discrepancies over the cash flow and that no till rolls were kept. The appellant explained that the cash flow discrepancy arose from additional rental income. A review of his tax returns revealed that any such rental income had not been declared in his tax return, and that he had received undeclared employment income. The officer formed the opinion that at least £700 of income had been suppressed each week. HMRC amended the appellant's tax returns for the years 2005 and 2006 and issued discovery assessments for 2003 and 2004 on the basis that £700 of income had been suppressed each week for each of the years under investigation. The appellant appealed. HMRC accepted that their figures were not precise but submitted that they were based on the available evidence, and were reasonable in the circumstances. The appellant did not attend the hearing and was not represented.

The judges found that the income estimates were fair and reasonable based on the information available to them. The onus was on the appellant to show otherwise and he had failed to do so. He had received notification of the hearing and it was in the interests of justice for the hearing to proceed in his absence. It followed that the appeal would be dismissed.

Appeal dismissed.

Tribunal: Judges Nicholas Aleksander and MM Hossain, ***28 October 2009***

Business Tax

Capital allowances and business cars

FA 2009 enacted an important new capital allowances regime for business cars with effect from 1 (or 6) April 2009.

For the first time, the legislation introduces a distinction in this area between the tax treatment of cars owned by companies and cars owned by unincorporated businesses. The latter have the advantage that cars with some element of private use (however small) are still kept in a single asset pool, while:

- cars owned by companies; and
- cars owned by unincorporated businesses where there is no private use restriction

will generally go into the main pool of plant or machinery attracting WDAs of 20% of their CO_2 emissions are between 111g/km and 160g/km (inclusive) or into the special rate pool attracting WDAs of 10% if their CO_2 emissions are more than 160g/km.

Thus, when a private use car is sold, a balancing adjustment (usually a balancing allowance) can still arise, whereas this will not be the case with all other cars. This can create the planning possibility illustrated below.

Illustration

This illustration is based on two cars, each with a cost of £60,000, being owned by two different businesses – one a company and the other a partnership. It is assumed that the cars have CO_2 emissions of more than 160g/km and that there is private use of the two cars. If one of the cars is sold for £30,000 during the third year, the comparative capital allowances position is as follows:

	Company	*Partnership*	
	Pool	*Car 1*	*Car 2*
	£	£	£
Cost	120,000	60,000	60,000
WDA (year 1)	12,000	6,000	6,000
	108,000	54,000	54,000
WDA (year 2)	10,800	5,400	5,400
	97,200	48,600	48,600
Sale proceeds	30,000	30,000	
	67,200		
WDA (year 3)	6,720		4,860
	£60,480		£43,740
BA		£18,600	

In other words, over the three years, the company has received allowances totalling £12,000 + £10,800 + £6,720 = £29,520, while the partnership has enjoyed allowances of £12,000 + £10,800 + £18,600 + £4,860 = £46,260.

Even ignoring the impact of private use adjustments and benefits in kind, this illustration suggests that, where possible, it will be preferable from a taxation point of view for proprietors' cars (and, particularly, expensive ones) to be owned by an unincorporated entity. Will we start to see more companies and partnerships operating in parallel?

A further planning point applies to pre-April 2009 'expensive' car acquisitions. It will be recalled that such vehicles continue to be held in their single asset pools for a further five years. This transitional period terminates on the last day of the first accounting period to end after 1 (or 6) April 2014. On this date, any unrelieved expenditure in the single asset pool will be transferred to the general plant or machinery pool with WDAs at 20% (ie. regardless of the car's CO_2 emissions).

In many cases, it will be beneficial to sell such cars *before* the expiry of the transitional period in order to trigger what will often be a substantial balancing allowance under the old rules.

Article by Robert Jamieson

Lecture B576 (12.55 Minutes)

FHLs - what to do now?

This tax-favoured UK investment provides the following advantages to 5 April 2010 only:

- CGT entrepreneurs' relief as a qualifying business disposal
- CGT hold-over relief
- CGT roll-over relief
- Income tax relief on losses against general income
- Pension scheme funding on the profits
- Capital allowances claimable for plant and machinery, even though used in a dwelling house (this is instead of the 10% wear and tear allowance); the £50,000 AIA is therefore available to this "business" although owners may not plan to spend anything like that amount

All furnished holiday letting properties are treated as a single business to 5 April 2010, but separate from any property business.

Requirements

The requirements are as follows:

- Commercial letting, which means on a commercial basis and with a view to the realisation of profits. See *Tax Bulletin Oct 1997*.
- Let furnished, so that tenant is entitled to use the furniture.
- Available for commercial letting to the public as holiday accommodation for at least 140 days in a 12 month period (which is the tax year, unless not let furnished in the preceding tax year in which case the period is the 12 months from the first letting; or where not let furnished in the next tax year in which case the period is the 12 months up to cessation)
- Actually so let for 70 days in the 12 month period.
- Not normally in the same occupation for over 31 consecutive days during a period of seven months in the 12 month period.

New rules

Under the guise that the UK tax-favoured rules may not be compliant with European rules, they are to be repealed altogether from 2010/11. From then, the lettings will simply be taxed as property income.

In the meantime, the rules WILL apply to non-UK lettings in the EEA as well as in the UK where the basic requirements are met.

Until 31 July 2009 HMRC said that they would accept late amendments for the year to 5 April 2007 (individuals) or accounting periods ending on or after 31 December 2007 (limited companies).

In fact, following a claim made for loss relief against general income going back to 2003/04 under the error or mistake provisions, HMRC allowed this after a struggle. You should therefore pursue such a claim where appropriate, not forgetting that the 6 year back claim reduces to 4 years for error or mistake claims made after 31 March 2010.

The draft legislation published with the PBR on 9 December 2009 contains no real surprises. Any unrelieved losses at 5 April 2010 are carried forward to set against future profits from a property letting business. The deemed trade ceases on 5 April 2010, which means that entrepreneurs' relief should be available on a disposal of the property by 5 April 2013 as the basic rule is that there is a 3 year allowable period after the trade has ceased.

Action points

- Identify clients letting overseas properties.
- Determine whether any UK income tax paid on the letting income in any of 2003/04 to 2007/08, after double tax relief, or whether a loss arose under UK legislation.
- If so, determine whether the lettings met the furnished holiday lets requirements.
- If they did, make error or mistake claims for 2003/04 to 2006/07 and amend the 2007/08 tax return* to claim any additional expenses (or loss relief against general income). Apply the new rules for 2008/09 and 2009/10.
- Identify clients who sold an overseas property in 2003/04 to 2007/08.
- Determine whether any UK CGT paid on the sale after double tax relief.
- If so, determine whether the letting met the furnished holiday lets requirements.
- If they did, make error or mistake claims for 2003/04 to 2006/07 and amend the CGT computations in the 2007/08 tax return* to claim business asset taper relief. Apply the new rules with entrepreneurs' relief claimed on a sale in 2008/09 or 2009/10.
- Consider a sale by 5 April 2013 so as to have CGT at 10% - provided any CGT rate increase does not affect the tax rate with entrepreneurs' relief.

* via error or mistake claim if after 31/1/10

IHT BPR on furnished holiday lets

IHT business property relief should also be available. Furnished holiday lettings do not specifically qualify for BPR despite the income tax and CGT reliefs afforded to them. However, para L99.3 of the obsolete Capital Taxes *Advanced Instruction Manual* says that they can qualify. The replacement material is supposedly in para IHTM25278 of the *Inheritance Tax Manual* but the text was originally mysteriously withheld under the Code of Practice on Access to Information. Fortunately that is no longer the case and the following is now stated:

"The Inland Revenue Solicitor has advised the office that in some instances the distinction between a business of furnished holiday lettings and, say, a business running a hotel or a motel may be so minimal that the Courts would not regard such a business as one of "wholly or mainly holding investments" for the purposes of IHTA84/S105 (3).

You should therefore normally allow relief where:

- *the lettings are short term (for example, weekly or fortnightly); and*
- *the owner - either himself or through an agent such as a relative or housekeeper - was substantially involved with the holidaymaker(s) in terms of their activities on and from the premises*

even if the lettings were for part of the year only.

You should continue to refer to Litigation Group cases where relief is claimed and:

- *the lettings are longer term (including Assured Shorthold Tenancies); or*

- *where the owner had little or no involvement with the holidaymaker(s) - for example a villa or apartment abroad; or*
- *where the lettings were to friends and relatives only; or*
- *where it is clear that no services were provided to the holidaymakers".*

However, that has been replaced somewhat ominously with the following:

IHTM25278 - Caravan sites and furnished lettings: Holiday lettings

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

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

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

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

Article by Gerry Hart

Lecture P578 (9.27 Minutes)

Furnished holiday lettings – transitional rules

HMRC confirmed in the Pre Budget Report in December 2009 that the favourable regime for furnished holiday lettings would be withdrawn from April 2010. The guidance provided by HMRC in December 2009 summarises the changes and their impact under the following headings:

- **Computation of business profits**: as the profits of a property business and those of a conventional trade are calculated on the same broad basis there is no particular impact on the computation of business profits, with the exception of capital allowances.
- **Capital allowances**: Capital allowances are not available in respect of plant and machinery in a dwelling house which is let. So the move to classifying FHL activities as normal lettings will mean that capital allowances cannot be claimed in respect of expenditure incurred on or after 6 April 2010 (1 April for companies). However, the guidance document states that capital allowances **will** be available on the remaining expenditure in the pool for businesses which have commenced prior to the date of change. No additional expenditure will of course be added to the pool of expenditure brought forwards as at 6 April 2010, but the balance on the pool at that point would be available to claim as a writing down allowance in future years.
- **Wear and tear allowance**: FHL operations are excluded from claiming the 10% wear and tear allowance, but will be permitted to claim in future as a result of the reclassification as pure rental activity. The HMRC guidance clearly states that this will be available in addition to any residual capital allowances available under the transitional rules described above
- **Landlords Energy Saving Allowance**: There is a tax allowance of £1,500 per property in respect of certain energy saving expenditure (such as insulation) which will now be available on FHL properties.
- **Losses**: Unused losses for income tax which are carried forward from 2009/10 will be treated as property business losses incurred in that year and will be available to set off against other property business profits in 2010/11 and subsequent years. The treatment will be similar for corporation tax.

- **CGT entrepreneurs' relief (ER)**: The business will cease to be a trading activity after 5 April 2010 and the business will deemed to have ceased for the purposes of Entrepreneurs' relief, even though the business may continue as an ordinary property business. This means that any disposal of assets in the three years following will be treated as the disposal of assets of a business which has ceased, and Entrepreneurs' relief will be available in respect of the disposal, provided any other relevant conditions are met. In particular, the FHL business would have to have commenced before 6 April 2009 in order to meet the criteria of one year in business. It is unlikely that disposals of shares in companies carrying on FHL activities will benefit from ER if disposed of after 5 April 2010. Relief may also be available on associated disposals in relation to actual cessations before or deemed cessations on 6 April 2010, provided the relevant conditions are met.
- **CGT rollover relief**: Rollover relief will no longer be available on the reinvested gains arising on FHL assets disposed of after 5 April 2010, unless the disposer carries on another separate trade in which case the rollover will be restricted to recognise the non trade use of the asset between 6 April 2010 and the date of disposal. Generally speaking, gains rolled into FHL assets are not affected, but of course these gains cannot be further rolled over on subsequent disposal. Where a gain has been held over into an FHL depreciating asset this gain will crystallise in the normal way – the change will not trigger an earlier charge to tax.
- **CGT holdover (gifts relief)**: There will be no relief for FHL assets gifted after the date of change, but assets which have been obtained subject to a hold over election will not be affected. Any latent gain will be taxed on eventual disposal as normal.
- **Relief for loans to traders**: Loans made before 6 April 2010 which have qualified for relief under the loans to traders provisions will not be affected by the change, and will continue to be a qualifying loan. No loans made after the date of change will qualify.
- **Substantial shareholding exemption (SSE)**: The relief available to exempt the gain on the disposal of a substantial shareholding in a trading company will terminate on 31 March 2010, but there is a transitional rule which will allow certain disposals to attract the exemption if sold within 2 years of the date of change.

The guidance document also includes HMRC's view on whether an FHL business might "convert" to a trading business by the provision of additional services. It is HMRC's view that the provision of additional services would amount to a separate trade, and that any charges for the use of the property should be separated from other charges, such as the provision of cleaning and fresh laundry or the provision of meals to form property income on the one hand and a small trading activity on the other. Charging separately would be an indication that there is a separate trade. It will be interesting to see whether this view is challenged through the courts.

Key planning points

Capital Expenditure.

Expenditure on furniture, fixtures and fittings, equipment etc. provided for tenants' use in residential furnished holiday lettings qualifies for a capital allowance claim up to 5 April 2010. After that date these costs will be covered by the annual Wear and Tear allowance (10% of adjusted rental figure), or a renewals basis claim.

The period up to 5 April 2010 represents a one off opportunity to incur additional capital expenditure which will never again qualify for allowances. The amount incurred will qualify for AIA and FYA of 40% on the excess. Any remaining balance would be available in later years as a WDA.

Note that by incurring expenditure, it is probable that the rent charged can be increased, thus increasing the amount of wear and tear allowance available, and thus providing even more tax allowances – in effect the allowances for the expenditure are being duplicated by the wear and tear allowance which is regarded as covering the same cost element.

Example

Mr & Mrs Black have three holiday cottages which are in need of refurbishment. They have elected to incur revenue expenditure of £15,000 in total on repairs and redecoration, all of which will be available for tax relief in 2009/10. They are also considering new furniture and kitchen equipment at a total cost of £75,000 for the three properties.

Timing the expenditure before 6 April 2010 will provide capital allowances of £75,000 in total over the period of claim. If the couple choose to claim the full allowances in 2009/10 this will create an allowance of £60,000 (being AIA of £50,000 plus FYA of £10,000 on the balance). This will leave £15,000 in the pool which can be claimed on a reducing balance basis at 20% in the future. The £60,000 allowance, together with the additional repairs of £15,000 will produce a loss in 2009/10 which can be set against other income or carried back up to three years against the profits of the FHL activity.

The couple may decide to make only a partial claim to the allowances in 2009/10 on the basis that the losses will be of limited benefit due to the unutilised personal allowances that will result. The expenditure, to the extent not covered by a claim, will be available to claim in future, and such claims will not affect the availability of the wear and tear allowance in respect of the properties.

Disposal of the properties

Until the transitional rules were published, it was widely believed that any disposal would have to be made before 6 April 2010 to benefit from Entrepreneurs' Relief. The transitional rules have presented a further opportunity – to retain the properties and dispose of piecemeal over the three years to 2013. This is because there is to be a deemed cessation of the FHL trade on 5 April 2010, irrespective of the use to which the properties are subsequently put.

The deemed cessation allows the disposal of the assets used in the trade within three years of the date of cessation – this is treated as a material disposal. The disposals therefore do not have to be made before 6 April 2010, and the sale could take place over the three years, utilising CGT annual exemptions in all three years if there are sufficient properties to make disposals every year. This would also allow the market values of the properties to recover, producing a higher gain to the taxpayer. However, clients contemplating this step should be warned that it is widely expected that CGT rates will rise in the near future, and there is no guarantee that the CGT rate net of relief will remain 10%.

Article by Rebecca Benneyworth

Lecture P579 (9.40 Minutes)

A Longworth & Sons Ltd v Revenue and Customs Comrs

The company was registered for gross payment status under the Construction Industry Scheme ("CIS") and accordingly fulfilled the three tests set out in FA 2004, Sch 11. HMRC cancelled its registration under FA 2004 s 66(1) following failures by the company to comply with its tax obligations during the qualifying period from 18 April 2007 to 19 April 2008 which related to late payments of PAYE/NIC as an employer and/or CIS tax, and which breached the "compliance test" in Sch 11, para 4. The company appealed and although it did not deny the breaches, it submitted there was a "reasonable excuse" for the purposes of FA 2004 Sch 11, para 4(4)(a) and TMA 1970 s 118(2) as its overdraft facility had been reduced to zero and it had brought in a finance company at the time of a drop in turnover to pay discounted invoices on a monthly basis. It had had suppliers and employees to pay and money had been put where it was most needed. It had not been aware of the possible impact of late payments to HMRC. The company also asked if it could be subjected to a financial penalty instead of withdrawal of registration for gross payment status, or if the penalty could be suspended.

The judge found that there was no reasonable excuse for the company's failures to comply with its tax obligations. The company had been in default on eight occasions during the qualifying period which was in part due to the company's lack of awareness of the serious consequences which might flow from such failures, partly by the use of the discounted invoicing system and partly by the company choosing to prefer to discharge liabilities other than its tax liability. The trading problems suffered by the company, whether due to cash flow or losses, were not exceptional. HMRC had taken the action they were entitled to take, and although the consequences were harsh, they were provided for by law. Neither of the requests made by the company were permissible in law and so could not be considered by the tribunal. It followed that the appeal would be dismissed. Appeal dismissed.

Mutch v Revenue and Customs Comrs

The appellant, a carpenter, provided carpentry services and, by the beginning of 2007, he had built up his business to meet with demand, employing 20 carpenters. He was registered for gross payment status under the Construction Industry Scheme ("CIS") and accordingly fulfilled the three tests set out in FA 2004 Sch 11. In mid 2007 his main client, a house building company working in Corby, suddenly stopped building and as a result the appellant's work dried up and he had to dismiss 14 carpenters, and at one stage he had to reduce his workforce to two carpenters. He still had to pay overheads, such as employer's liability insurance, and meet compulsory health and safety standards. As a result the appellant had insufficient funds to make certain tax payments in 2008 by their due dates, although he later paid the outstanding amounts. HMRC withdrew his gross payment status for the failure to comply with his tax obligations within the qualifying period, in breach of the "compliance test" in FA 2004 Sch 11, para 4. The appellant appealed contending that his insufficiency of funds amounted to a reasonable excuse for those failures.

The judge considered that the correct approach in determining whether or not a reasonable excuse existed in the context of the CIS was for the tribunal to make a comparison with a person in a similar situation to that of the actual taxpayer who was relying on the reasonable excuse defence. The tribunal should then ask itself—with that comparable person in mind—whether, notwithstanding that person's exercise of reasonable foresight and of due diligence and a proper regard for the fact that the tax would become payable on the particular dates, those factors would not have avoided the insufficiency of funds which led to the failures. In the present case the drop in building work in the Corby area was sudden and severe. The reasonable competent businessman taken for comparison would have reacted in the same way, both to the demand before in 2007 and to the drop in the work after that; he would not have had any better foresight than the appellant. Next the reasonable competent businessman must be taken to have exercised due diligence and a proper regard for his tax obligations. In the circumstances the appellant had operated in the real world as it existed at the end of 2007. He dealt in a fair and business-like way with the demands on his available cash resources and came up to the required standards contemplated by the expression "reasonable excuse" in the context of CIS. The appellant dealt with his tax obligations as promptly and as reasonably possible by paying the tax outstanding as soon as he had funds available. The building climate had not changed much; but assuming the appellant had a reasonable excuse in the year 2007/08, his compliance arrangements had apparently been carried out promptly since then. Therefore there was no reason to doubt future compliance on his part. It followed that the appeal would be allowed.

Appeal allowed.

Tribunal—Judge Sir Stephen Oliver QC, ***7 July 2009***

Prior Roofing Ltd v Revenue and Customs Comrs

The appellant company was a specialist roofing contractor working exclusively for major house building companies. It was registered for gross payment status under the Construction Industry Scheme ("CIS") after fulfilling the three tests set out in FA 2004 Sch 11. During the relevant qualifying period there were eight instances of non-compliance with the company's financial obligations, although only one of the payments was more than 14 days late. HMRC cancelled the registration for gross payment status, for failure to fulfil the compliance test set out in FA 2004 Sch 11. The company appealed, admitting the defaults, but contending that the failure to meet the requirements of the compliance test could reasonably be excused. It submitted that the non-compliance period occurred during a period when there had been a particularly sharp down-turn in the fortunes of the house building industry. Its monthly turnover had declined from £400,000 to around £100,000 within a matter of a few months. It became a major challenge to the management simply to survive throughout the period. The bank had refused to extend its overdraft and its directors sacrificed some £50,000 of the salaries due to them and injected additional capital, raised through personal borrowings, of £160,000 into the company. It hoped, with patience on the part of its suppliers and HMRC, that it would be able to weather the financial storm. HMRC submitted that whilst the decision to withdraw gross payment status from

the company might seem harsh for "such apparently minor failures", there was a need for all contractors and sub-contractors to be treated equally and fairly. Difficult trading conditions were part and parcel of business and could not be accepted as a reasonable excuse for late payment. The rules were clear and the company had contravened them; the consequences for any contractor in a similar position would be the same.

The judge considered that equality and fairness could only be achieved by looking with great care at the particular circumstances of each individual company and thereafter making a considered decision, particularly where the breaches had been described as "apparently minor failures". It might not be the case that all contractors and subcontractors were as a matter of fact in precisely the same position as the company in terms of the impact of the twin effects of a radical downturn in business volume affecting, in particular, the roofing business and the refusal of banks to assist customers which in more normal times might reasonably expect to be supported. Neither the construction industry nor the banking sector was working normally at the time the failures occurred. Equality of treatment would also dictate that consideration be given to the steps taken by a company's management to cope with such difficulties. It could not be right in terms of achieving equality and fairness that a company whose directors took no or few steps to try and meet its obligations to HMRC should be treated exactly the same as a company whose directors had taken every reasonable step available to it to try and meet its obligations. The fact that the company had declined HMRC's offer of a review by an independent reviewer was perhaps unfortunate as that would have provided an opportunity to explain how the exceptional market conditions were affecting the company and the steps it had taken to try and ensure compliance with the scheme. However on the facts the circumstances were wholly exceptional and led directly to the failures in compliance. The directors were managing an exceptional situation on a day-to-day basis controlling cash as best they could to ensure that they met, to the best of their ability, their obligations to HMRC under the CIS. It followed that the circumstances relating to the exceptional and extraordinary trading conditions it experienced, coupled with the unhelpful banking environment which prevailed during the review period and which the company faced, taken together constituted a reasonable excuse for its failure to make the payments due within the review period by their respective due dates and that that excuse continued throughout the review period. However, the decision was not to be considered as in any way providing a "blanket excuse" for companies adversely affected by the problems which had beset British industry over the past 18 months, and it had no wider application. It was based on the particular circumstances of the company's situation and the reasons giving rise to its cash flow problems. The appeal would be allowed.

Appeal allowed.

Tribunal—Judge C S Hacking LLM FCIArb, ***11 November 2009***

Strongwork Construction Ltd v Revenue and Customs Comrs

The appellant company had registered for gross payment status under the Construction Industry Scheme ("CIS") after fulfilling the three tests specified in FA 2004 Sch 11. The company was late in making 10 PAYE payments in the year to 23 January 2008 and so HMRC decided to withdrew the company's gross payment status under FA 2004 s 66(1)(a) on the basis that it failed the compliance test set out in Sch 11, para 12(1)(a). The company did not dispute the defaults but contended that it had a "reasonable excuse" for the purposes of FA 2004 Sch 11, para 12(3) for the failure to comply based on cash flow problems; personal injury suffered by H, a company director and employee; and the adverse impact on its business. It contended that it was owed £52,000 after two debtors went bust in mid-2007 and early 2008; H broke his back in September 2007 and was off work for five to six months and his wife, the other director, had to take over the running the business in H's absence; and the law was unreasonable to remove its gross payment status for ten fairly minor defaults when the effect of the loss of status might be to put it out of business. It supplied plant and materials as well as labour and a 20% deduction from all payments due to it could cause major cash flow problems as it would still have to pay for the plant and materials. It had realised the seriousness of the need to comply and had taken steps to ensure that PAYE was paid on time, through by BACS system of payment. Furthermore, there was no benefit to HMRC removing the company's gross payment status as by putting it out of business they would lose tax revenue, and 22 jobs were at stake.

The tribunal had no discretion to take the impact of the loss of gross payment status into account as it could not consider proportionality, having regard to the decision in *Barnes (Inspector of Taxes) v Hilton Main Construction* [2005] EWHC 1355 (Ch), [2005] STC 1532. Furthermore, although a broken back could amount to a reasonable excuse for non-compliance where it caused the defaults and if, within a reasonable time, the business took steps to get back into compliance, in the instant case by the time H broke his back the company was already in default sufficient times to lose its gross payment status and the defaults continued until January 2008. It followed that the appeal would be dismissed.

Appeal dismissed.

Tribunal—P Petherbridge (Chairman) and B Mosedale, ***3 November 2009***

Corporation Tax

Extracting Profits from a Limited Company – 2010/11

Small company – profits under £50,000
For a small company the decision as to how to extract profits is a relatively simple one – when the company is paying small company rates of corporation tax, the profit will be extracted in general by payment of a dividend as this produces the cheapest tax outcome for the owner manager. The computations are as follows :

Profit	49,188
Salary	(5,720)
Taxable profit	43,468
Corporation tax	9,128
Net profit	34,340
Dividend (net)	34,340
Gross dividend income	38,155
Tax liability on dividends	NIL

This computation holds up to the profits shown – every additional £1 distributed costs 25p in tax, so the net marginal tax rate is 40.75% on profits earned.

Total tax liability on £50,000 profit	£9,459	(18.9%)

Although a very modest saving at this level compared to the liability on a sole trader (at 41%), the corporate structure has benefitted from the saving of 8% Class 4 National Insurance contributions on the basic rate band of income.

The cost of extracting all of the profits as salary is considerably higher :

Profit	50,000	
Salary	(44,975)	
Salary	(5,025)	
Taxable profit	NIL	
Corporation tax	NIL	
PAYE on salary	7,920	
Employee NIC on salary	4,209	
Employer NIC (as above)	5,025	
Total tax and NIC liability	£17,154	(34.3%)

So at this level, clearly dividend is preferable, and the best outcome is obtained when a salary equal to the earnings threshold is paid (see above) to maximise the use of personal allowances. Increasing the salary to the personal allowance will trigger an NIC charge, which erodes the tax benefit and adds complexity so this is normally the preferred route.

Increasing the salary
Although payment of salary carries quite a significant NIC cost, many businesses prefer to pay a modest salary so the costs of this are detailed below, continuing with the profits of £50,000 for illustrative purposes :

(a) Salary of £10,000 – roughly minimum wage

Profit	50,000	
Salary	(10,000)	
Employer NIC	(548)	
Taxable profit	39,452	
Corporation tax	8,285	
Net profit	31,167	
Dividend (net)	31,167	
Gross dividend income	34,360	
Tax liability on dividends	109	
PAYE on salary	705	
Employee NIC on salary	471	
Total tax liability on £50,000	£10,118	(20.2%)

(b) Salary of £20,000

Profit	50,000	
Salary	(20,000)	
Employer NIC	(1,828)	
Taxable profit	28,172	
Corporation tax	5,916	
Net profit	22,256	
Dividend (net)	22,256	
Gross dividend income	24,729	
Tax liability on dividends	192	
PAYE on salary	2,705	
Employee NIC on salary	1,571	
Total tax liability on £50,000	£12,020	(24.0%)

National Minimum Wage

Guidance published by the Tax Faculty of ICAEW and approved by both the DTI and HMRC indicates that there is no need to pay the National Minimum wage to directors, provided they do not have a specific written contract of employment with the company. Should there be a contract of employment in place when a director is appointed, this should be terminated on appointment if it is desired to exclude the provisions of the National Minimum Wage. Note that employment of the spouse, when not a director or other officer of the company is affected by National Minimum Wage. A record of hours worked and wages paid is advisable.

Benefits

The benefit of basic state pension and a modest earnings related amount (calculated at pay of around £13,000) is available at pay equal to the earnings threshold, so there is no benefit to the earner in increasing the pay until the £13,000 limit is exceeded. At salary of £20,000 slightly more earnings related pension would be available but at significant extra NIC cost.

Large company – full rate of corporation tax

The tax efficiency of profit extraction methods in 2010/11 needs to recognise the additional rate of income tax on dividends and the withdrawal of personal allowances, depending on the amount the individual wishes to extract. The following sample calculations all assume corporation tax relief for salary at 28%, and no other income sources for the recipient. We examine various post tax income levels for the individual and contrast dividend with salary initially, disregarding the absolute profit level and tax charge in the company, taking into account only the impact of the income withdrawn.

(a) Net income in 40% tax band below £100,000 : say £65,000

Dividend only		
Net dividend drawn	73,504	
Gross Income	81,672	
Tax charge	8,504	
Net dividend	65,000	
Profit needed to provide income	**102,089**	
Corporation tax thereon	28,585	
Total tax charge	***37,089***	***(36.3%)***

Salary only		
Gross pay	99,474	
Employer NIC	12,001	
Total cost to company (profit needed)	**111,475**	
Corporation tax thereon	NIL	
PAYE on salary	29,720	
Employee NIC	4,754	
Net pay	65,000	
Total tax and NIC charge	***46,475***	***(41.7%)***

Optimum : Salary of £5,720

Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	67,593	
Gross dividend income	75,103	
Tax charge	8,313	
Net dividend	59,280	
Profit needed to provide dividend	93,879	
Corporation tax thereon	26,286	
Total profit needed to provide income	**99,599**	
Total tax charge	***34,599***	***(34.7%)***

(b) Net income such that no personal allowances available – say £86,000

Dividend only		
Net dividend drawn	103,446	
Gross Income	114,940	
Tax charge	17,446	
Net dividend	86,000	
Profit needed to provide income	**143,675**	
Corporation tax thereon	40,229	
Total tax charge	***57,675***	***(40.1%)***

Salary only		
Gross pay	139,457	
Employer NIC	17,118	
Total cost to company (profit needed)	**156,575**	
Corporation tax thereon	NIL	
PAYE on salary	48,303	
Employee NIC	5,154	
Net pay	86,000	
Total tax and NIC charge	***70,575***	***(45.1%)***

Optimum : Salary of £5,720		
Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	97,536	
Gross dividend income	108,373	
Tax charge	17,256	
Net dividend	80,280	
Profit needed to provide dividend	135,467	
Corporation tax thereon	37,931	
Total profit needed to provide income	**141,187**	
Total tax charge	***55,187***	***(39.1%)***

(b) Net income such that 50% tax liability is reached (no personal allowances available) – say £125,000

Dividend only		
Net dividend drawn	159,002	
Gross Income	176,669	
Tax charge	34,002	
Net dividend	125,000	
Profit needed to provide income	**220,836**	
Corporation tax thereon	61,834	
Total tax charge	***95,836***	***(43.4%)***

Salary only		
Gross pay	216,898	
Employer NIC	27,031	
Total cost to company (profit needed)	**243,929**	
Corporation tax thereon	NIL	
PAYE on salary	85,969	
Employee NIC	5,929	
Net pay	125,000	
Total tax and NIC charge	***118,929***	***(48.8%)***

Optimum : Salary of £5,720		
Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	152,959	
Gross dividend income	169,954	
Tax charge	33,679	
Net dividend	119,280	
Profit needed to provide dividend	212,443	
Corporation tax thereon	59,484	
Total profit needed to provide income	**218,163**	
Total tax charge	***93,163***	***(42.7%)***

After this point, the marginal rates of tax are : Salary 63.5%, dividend 54.0%.

Medium sized company – marginal rate of corporation tax
This model is very similar to that produced above for the larger company, but the tax relief in the company is give at 29.75% rather than 28%. This can make a difference to the salary model, and indeed for the marginal income of £100 makes the decision very close indeed. However, the cost of

the salary at the basic rate band, with full 11% employee NIC liability still undermines the benefit of the higher rate of corporation tax relief.

(a) Net income in 40% tax band below £100,000 : say £65,000

Dividend only		
Net dividend drawn	73,504	
Gross Income	81,672	
Tax charge	8,504	
Net dividend	65,000	
Profit needed to provide income	**104,632**	
Corporation tax thereon	31,128	
Total tax charge	***39,632***	***(37.9%)***

Salary only		
Gross pay	99,474	
Employer NIC	12,001	
Total cost to company (profit needed)	**111,475**	
Corporation tax thereon	NIL	
PAYE on salary	29,720	
Employee NIC	4,754	
Net pay	65,000	
Total tax and NIC charge	***46,475***	***(41.7%)***

Optimum : Salary of £5,720		
Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	67,593	
Gross dividend income	75,103	
Tax charge	8,313	
Net dividend	59,280	
Profit needed to provide dividend	96,218	
Corporation tax thereon	28,625	
Total profit needed to provide income	**101,938**	
Total tax charge	***36,938***	***(36.2%)***

(b) Net income such that no personal allowances available – say £86,000

Dividend only		
Net dividend drawn	103,446	
Gross Income	114,940	
Tax charge	17,446	
Net dividend	86,000	
Profit needed to provide income	**147,254**	
Corporation tax thereon	43,808	
Total tax charge	***61,254***	***(41.6%)***

Salary only		
Gross pay	139,457	
Employer NIC	17,118	
Total cost to company (profit needed)	**156,575**	
Corporation tax thereon	NIL	
PAYE on salary	48,303	
Employee NIC	5,154	
Net pay	86,000	
Total tax and NIC charge	***70,575***	***(45.1%)***

Optimum : Salary of £5,720		
Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	97,536	
Gross dividend income	108,373	
Tax charge	17,256	
Net dividend	80,280	
Profit needed to provide dividend	138,841	
Corporation tax thereon	41,305	
Total profit needed to provide income	**144,561**	
Total tax charge	***58,561***	***(40.5%)***

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(b) Net income such that 50% tax liability is reached (no personal allowances available) – say £125,000

Dividend only		
Net dividend drawn	159,002	
Gross Income	176,669	
Tax charge	34,002	
Net dividend	125,000	
Profit needed to provide income	**226,337**	
Corporation tax thereon	67,335	
Total tax charge	***101,337***	***(44.8%)***
Salary only		
Gross pay	216,898	
Employer NIC	27,031	
Total cost to company (profit needed)	**243,929**	
Corporation tax thereon	NIL	
PAYE on salary	85,969	
Employee NIC	5,929	
Net pay	125,000	
Total tax and NIC charge	***118,929***	***(48.8%)***
Optimum : Salary of £5,720		
Gross pay = net pay	5,720	
Corporation tax thereon	NIL	
Net dividend drawn	152,959	
Gross dividend income	169,954	
Tax charge	33,679	
Net dividend	119,280	
Profit needed to provide dividend	217,735	
Corporation tax thereon	64,776	
Total profit needed to provide income	**223,455**	
Total tax charge	***98,455***	***(44.1%)***

After this point, the marginal rates of tax are : Salary 63.5%, dividend 55.2%.

Impact of proposed NIC rises in 2011/12

In 2011/12 it is planned to increase NIC by 1.0% on each band. The salary method is consistently the most expensive way to distribute profits in any event, and the increase in NIC will increase the advantage conferred on withdrawal by way of dividend. Ultimately in both 2010/11 and 2011/12 the mix of withdrawal will reflect a number of factors, but the computations above provide some ground rules for the decisions.

Article by Rebecca Benneyworth

Lecture B577 (16.36 Minutes)

Debit balances on directors' loan accounts

Where directors have racked up adverse balance on loan accounts it is not unusual for the directors to vote through a dividend at some point, which when put to the credit of the loan account reduces the indebtedness. This session is not intended to provide a guide to the company law aspects of declaring an interim or final dividend but seeks to examine what steps are appropriate when there are insufficient reserves from which to declare a dividend.

Option 1 – pay S 419 tax liability

If the loan is outstanding at the end of the tax year, a liability to tax under section 419 ICTA crystallises. The tax is payable on the same date as the normal corporation tax liability, and is declared on the corporation tax return. The tax is calculated at 25% of the amount of the loan and is in effect a loan to HMRC which carries no interest.

If the loan is repaid or written off (see below) before the tax falls due at the 9 month point, the tax credit under section 419(4) arises on the same date, and no tax is payable. If the 9 month date is passed without repayment or write off, the credit under section 419(4) is timed at 9 months after the end of the period in which the repayment or write off occurred.

In some cases, clients will have a debit balance in the accounts showing section 419 which is repayable on repayment of the loan, as once the loan is repaid the 419 liability is cancelled and the tax returned to the company.

It is worth noting that there is no automatic mechanism for repayment of section 419 tax liabilities, which needs to be done by writing to the relevant corporation tax district. This can be the cause of significant delay in practice.

Option 2 – declare bonus or salary

When the company is loss making, a dividend would require taxable profits from which to pay the dividend, but voting through a bonus or salary payment can be used to increase a loss, potentially reducing future corporation tax payments, or even at present providing additional loss which can be subject to the three year carry back.

The rules about when the liability is incurred for accounting purposes determine in which period the credit is taken for the salary – that is which profits benefit from the extra costs. It is not possible to "backdate" a salary payment and obtain tax relief for it in the previous year – the liability must exist at the end of the accounting period for there to be a liability to recognise, even if the amount cannot be quantified.

So declaring a bonus and accounting for the tax and NIC would create sufficient credit to allow the director's account to return to nil; the tax cost can. Of course be significant as the cost will include PAYE and NIC (both employee and employer elements) but this cost is of course offset by the corporation tax relief gained. In the event that distributable profits are not foreseen for the medium term this may be considered an appropriate option.

Example

The director has a loan outstanding of £20,000. The options set out above are :

Option 1 : pay S 419 tax	£5,000

This is not a permanent liability, but the cashflow impact is taken 9 months after the end of the period in which the debt arose.

Option 2 : make bonus payment

Gross pay	26,197	
PAYE on gross		3,944.40
Employee NIC on gross		2,252.47
		6,196.87
Employer NIC on gross		2,621.06
Corporation tax relief on total cost (at 21%)		(4,750.42)
Net tax cost of bonus payment		£4,067.51

So the cash flow effect of paying a bonus rather than the section 419 tax saves £932.49 and may present a more acceptable solution for companies in dire problems. As this is being paid and declared in the subsequent period, the payment may well be due later than the section 419 liability – however, the salary payment must be due and processed by the 9 month point otherwise the loan will remain outstanding and the section 419 liability payable which then represents a one year cash flow disadvantage of £5,000 in addition to the tax and NIC due.

There are particular dangers in creating a loan account credit with a net bonus if there is any risk of the tax and NIC remaining unpaid by the company which is subsequently de4clared insolvent. This is best illustrated by a judicial review case which was brought under the previous version of the PAYE Regulations.

Director's loan accounts : Net bonus to clear debit balance

Where a debit balance has arisen on a director's account and a net bonus is voted through in the accounts to clear the balance, practitioners should bear in mind the McVeigh case and amend their procedures accordingly, if necessary. In particular in the McVeigh case, no actual payment of salary (net pay) was made, as the director had already accumulated a substantial debit balance on his loan account, and the net salary was intended to clear this indebtedness.

Wilful failure to deduct : R v CIR ex parte McVeigh

The applicant was a director of a company who owned 50% of the share capital. During 1989/90 and 1990/91, each director was paid a salary and voted a bonus. In the books of the company, various credit entries were made to an account entitled "Director's loan : Mr J McVeigh" each described as "net bonus". Further entries were credited to an account headed "Directors loan : PAYE and NIC" which appeared to be the PAYE and NIC related to the bonus payments. So the salary "payments" were made by journal entry which entries were put to the credit of loan accounts from which the directors had already drawn down substantially in round sum amounts.

No amounts of PAYE or NIC were paid by the company, nor did the director declare the amounts in his personal tax return. The Revenue (now HMRC) made determinations obliging the company to pay the tax and NIC, but by now the company was in insolvent liquidation and did not pay.

The Revenue then directed the applicant under Reg. 49(5) Income Tax (Employments) Regulations 1993 SI 1993 No 744 to pay the tax personally. In order to do this the Revenue must show (under Reg. 42(3)) that :

(1) the company had failed to deduct the tax,

(2) it had failed to do so wilfully, and

(3) the employee had received the emoluments knowing of the wilful failure to deduct.

Although the recent rewrite of the PAYE Regulations have substituted new law for the above measures, the effect is the same.

The applicant applied for judicial review on the grounds that the company had deducted tax, by reference to the ledger entries concerned. The decision considered the date of payment of the sums as the opportunity for the tax to be deducted from the payment – holding that to deduct was to pay a lesser sum, so that deduction could only be made at the time of payment. Payment was made in round sum amounts some time before the bonus amounts were recorded and thus at the time payment was made no deduction was suffered. It was therefore held that the entries showing net pay and recoding tax and NIC deducted were merely accounting entries and did not constitute deduction of tax. The appeal was therefore dismissed.

Although the case was brought under the previous PAYE Regulations, the legislation remains intact under current PAYE Regulations at Regulation 81(2). (SI 2003 No 2682). These Regulations therefore create a personal liability on a director in respect of the PAYE which should have been deducted. Note that although the Regulations permit recovery from the recipient of gross pay (being any employee) it is exceptional for HMRC to use this power against anyone other than a director of the company concerned.

Liability to NIC

It is likely that the director would also be personally liable for the NIC in a case of this sort, as the Social Security Administration Act 1992 places a personal liability on an officer of a company which has failed to make payments of NIC as they are due. The liability arises where a company has failed to pay contributions due by it and that failure is due to the fraud or neglect of an officer of the company. Personal liability notices will be raised which the director can appeal against, but it is possible in the circumstances set out above that HMRC would seek to recover the NIC in the event that the company became insolvent. Current case law indicates that this option is most likely where "pheonixism" is suspected.

Option 3 release or write off the loan

If the company so chooses the principal of the loan may be written off or released, and the tax outcome may be viewed as preferable. The comments above relating to the timing of any write off and the timing of the credit under Section 419(4) should be borne in mind when considering the cash flow implications. A worked example follows the descriptive narrative below.

The tax implications - director

The write off of the loan is taxed on the recipient as if it were a distribution so that it is deemed to be a payment net of the normal dividend tax credit. A tax liability will only arise to the extent that the director concerned has a higher rate liability in respect of the income. Naturally the amount of the loan should be grossed up for the tax credit to determine the tax liability. This tax treatment is statutorily required and takes precedence over any liability under ITEPA 2003 as earnings.

The NIC implications – director and company

HMRC's view is that when the loan is written off it becomes earnings liable to NIC. There is no clear guidance on how the NIC is to be accounted for as the payment of earnings was made sometime in the past when the loan was advanced, but here we assume that the director accepts liability for his portion and makes the relevant payment back to the company (or indeed this forms a new debit to the loan account. For these purposes we assume that the director has no other earnings from the company and that both employer and employee liabilities are settled.

Tax implications – the company

The write off of the loan to the director is a loan relationship debit. The debit would be allowable under the loan relationship rules as a loss on a non trading loan relationship. In order to do so, it would need to satisfy the unallowable purpose test. This presents some challenges, as the purpose of the loan would need to be examined in some detail. There is quite a common belief that a tax deduction would be available for the write off, but this view is open to challenge for the following reasons.

- The loan must not have been made with the intention of writing it off, otherwise the unallowable purpose test would apply and no deduction would be available. This tax treatment would therefore only apply to loans in existence rather than a loan made as a result of delivering this advice as the separation of the making of the loan from the subsequent writing off would be difficult to demonstrate otherwise.

- If the loan is not made on a commercial basis with a suitable interest charge it has been common for HMRC to challenge such loans when made by pension schemes and charities to other related parties.
- The HMRC guidance on the subject of unallowable purpose hints at this approach (see below, although directed at loans made prior to 2002, this principle is likely to be persuasive). This is further borne out by the description of when the test would not be in point, referred to in the previous paragraph of guidance, which covers loans not on a commercial basis made by exempt bodies.
- If the loan is made as an advance of salary it is likely that the write off would be viewed as payment of the salary and therefore not a loan write off but a payment taxable under ITEPA.
- If the loan was made in anticipation of future dividends (as "drawings") and arose as a build up of various withdrawals it is my view that the unallowable purposes test would also apply, as the lending of the money does not arise in connection with the company's trade or business.

HMRC guidance on unallowable purpose

CTM56780 – situations where para 13 (unallowable purposes test) would apply

a. that, subject to the comments at CTM56770(d) and (e), relate to the write-off of loans where the purpose of the loans was not amongst the business or other commercial purposes of a company. An example of a loan of this nature would be an interest-free loan made by a company, whose business consists in operating a widgets retail outlet, which had lent the money to a football club supported by one of the directors of the company for the purpose of providing financial support to the football club. Furthermore, if the company borrowed to make the loan to the football club, then paragraph 13 would normally also apply to disallow the loan relationship debits relating to the interest or other finance costs on that borrowing. If, however, the purpose of the loan included a commercial or other business purpose such as advertising, then this would be taken into account in arriving at the amount attributable to the unallowable purpose on a just and reasonable basis (Paragraph 13(1));

b. that, subject to the comments at CTM56770(d) and (e), relate to a borrowing the proceeds of which are used in such a way that the company cannot or does not expect to make an overall pre-tax profit. An example would be where a company borrows at interest and on-lends at a rate of interest that is less than the rate of interest on the borrowings; or

CTM56780 – situations where para 13 (unallowable purposes test) would not apply

b. that relate to a borrowing from an exempt body (such as a pension fund), even if that exempt body is connected with the borrower, provided the arrangements are commercial;

Note : Para 13 is the reference to the legislation as originally written in FA 2006 – the appropriate statutory reference is now CTA 2009 S441

Conclusion

It is likely, therefore, that the tax treatment on the company would be to add back the deduction from profits in the corporation tax computation. (The write off is taxed as a distribution but remains a profit and loss deduction for accounting purposes, so has the benefit of not requiring distributable profits to support it).

Example – loan write off

Instead of options 1 or 2 above it has been decided to write the loan off within the 9 month period before the section 419 liability falls due in order to benefit from immediate relief under section 419(4). The director concerned has drawn no other income during the year concerned.

Option 3 : write the loan off

Loan write off	£20,000
Gross taxable amount	£22,222
Tax liability on the director	NIL
Employee NIC on gross of £20,000	1,570.80
Employer NIC on gross of £20,000	1,827.84
Corporation tax relief on 'Ers NIC (at 21%)	(383.85)
Net tax cost of bonus payment	£3,014.79

There will also be a small amount of tax and NIC due on the benefit in kind of the interest free loan – depending on the period for which it was outstanding (see below). This has reduced the net cost by £1,053 as against the payment of salary.

Other tax implications

The liability to income tax on the benefit in kind if the loan is made interest free should not be overlooked, and indeed arrangements made if necessary to draw up the loan account as at the end of the fiscal year for the purpose of computing the benefit in kind charge and the related Class 1A NIC which must be returned and the liability paid in July following the end of the tax year. There are fixed penalties for failure to file the P11D(b) which could add considerably to the costs if this is overlooked.

Article by Rebecca Benneyworth

Lecture B578 (13.43 Minutes)

Value Added Tax

New EU VAT Refund Procedures

In early 2008 the EU Council of Ministers formally adopted a series of changes to the EU VAT rules with effect from 1 January 2010, known collectively as the VAT Package. The VAT Package included proposals for much improved cross-border refund procedures.

The refund system enables a business that incurs input VAT in another EU Member State, where it is not established and makes no supplies, to recover VAT from the Member State of Refund (MSR). Before outlining the new electronic procedures, it is worth a recap of the old rules, under which many claimants used to struggle to obtain timely repayments of VAT.

Former, Paper-Based VAT Refund Procedure

The former, paper-based system (under the Eighth VAT Directive) was extremely burdensome for businesses. First there was the language barrier: claim forms printed in the local language had to be obtained from the MSR and completed in that country's language. Then it was a case of trying to establish whether the VAT was recoverable in the MSR, or whether restrictions applied. Claimants had to obtain a Certificate of Status from their local tax authority, which in the UK meant remembering to request these from HMRC at least two weeks before the deadline, together with appropriate letters of authority (also translated into the local language). These documents, together with all of the original purchase invoices, had then to be with the MSR no later than six months after the calendar year in which the VAT had been incurred.

Where large volumes of invoices were involved (which may have amounted to a substantial claim), this meant sending large parcels to tax authorities in other Member States, invariably by a courier who was unable to obtain any acknowledgement of receipt on delivery. It was then a case of wait and see if the claim had in fact reached the intended destination. Assuming the package arrived safely, there was the invariable rejection of invoices or documents which were not deemed to be 100% perfect. Certain Members States simply never responded to enquiries, with no regard to the supposed six-month processing limit; other Member States introduced a number of other ad hoc tests to be complied with, if there was to be any prospect of a successful repayment.

As a result of these difficulties many EU businesses chose to appoint agents to make claims on their behalf, or simply not to submit a claim.

New, Electronic VAT Refund Procedure

Thankfully the paper-based system has now been consigned to history and replaced by an electronic approach, which went live across the EU on 1 January 2010.

Under the new procedure requests for refunds will continue to be dealt with by the MSR. However, each Member State must now make available an electronic interface to its national businesses, through which those businesses can submit claims to other EU Member States and through which claims will be received.

This EU-wide electronic refund scheme results in a number of key benefits (summarised below), including that:

- information will be sent by the business to the MSR via a web portal in the claimant's own country and via its own tax authority (HMRC in the case of UK businesses)
- all EU applications have standard fields of information and the description of the business activity may also have standardised codes (standard fields and coding will enable the claim to be completed almost entirely in the claimant's own language and although there may be some free text on occasion, Member States are expected to allow businesses to use English)
- additional time is now allowed for claimants to submit claims, moving from the previous six months to within nine months of the end of the year of the claim period (that is, 30 September rather than 30 June)

- claimants can check on the progress of the refund claim throughout the process through notification, initially from the Member State of Establishment (MSE), thereafter from the MSR at key stages
- there are shorter, fixed and certain time limits for processing of claims, with appeals procedures and interest payable to the business if the time limits are not met.

Summary of benefits

- Claims are made electronically via HMRC
- No postage costs
- The time limits for submitting claims extended to nine months
- Certificates of Status no longer required
- Only higher value invoice need to be provided
- Claims can be made in English
- Claimant receives acknowledgment of the claim and updates
- MSRs have a shorter period to process claims
- Interest is due where delays occur
- There is an appeals procedure

This results in a new and hopefully fairly straightforward refund regime, at a reduced administrative cost.

It should be noted that the refund procedure for non-EU businesses claiming VAT incurred in the EU (under the 13th VAT Directive) has not changed, and therefore is still subject to paper applications.

Registering for the New Electronic VAT Refund Service

UK businesses need to register on the UK portal via the Government Gateway website (www.gateway.gov.uk). Once registered, they will find the EU VAT refund service has become available via HMRC's VAT online service.

Submission of Claims on the UK Portal

When submitting claims, a UK business will need to record some basic details (such as name, address, VAT number, bank account details) and declare that (in line with the current exclusions) it does not account for VAT under the margin or fl at rate scheme, nor make any supplies in the MSR. This information will be stored and automatically transposed onto the individual claim forms for each MSR, as each claim is made. Unlike the current paper system, these details need to be recorded only once per log-in session (and will then apply for all claims completed during that session), although they can be updated if necessary.

As HMRC will be verifying these basic details, certificates of UK VAT status to support claims will no longer be necessary. The UK portal will also identify errors in syntax and field completion, and 'flag' these to the applicant for correction as each field is completed. Failure to correct these errors will not prevent the claim from being forwarded to the MSR but the MSR may reject the claim for these or other reasons. In such cases the MSR will notify the business of the reason(s) for rejection.

Who can make the application?

A VAT-registered business established in a Member State other than the MSR may make claims, or claims may be submitted by an authorised agent on the business' behalf.

Claims by VAT group members can only be made in the representative member's name.

The applicant must meet the following conditions:

- The business is not registered, liable or eligible to be registered in the MSR.
- The business must have no fixed establishment, seat of economic activity, place of business or other residence in the MSR.
- During the refund period the business must not have supplied any goods or services in the MSR, with the exception of:
  - transport services and services ancillary thereto
  - supplies of goods or services where VAT is payable by the person to whom the supply is made under the reverse charge procedure.

Basic registration checks will be carried out by the MSE (HMRC in the case of the UK) before the application is forwarded electronically to the MSR.

The MSE will not forward the application to the MSR if, during the period of refund, any of the following apply:

- the applicant is not a taxable person for VAT purposes
- the applicant makes only exempt supplies
- the applicant is covered by the exemption for small enterprises
- the applicant is operating the flat rate scheme for farmers.

If the MSE decides not to forward the application it must notify the claimant of this decision.

Claims

A separate claim must be completed for each MSR. Claims can be started and stored in an incomplete state on the online system and may be recalled and finalised to be submitted at a later date.

The refund period must not be more than one calendar year or less than three calendar months, unless the period covered represents the remainder of a calendar year (for example, where interim claims have already been submitted earlier in the year).

If the refund claim relates to a period of less than a calendar year but not less than three months, the minimum amount claimable is €400, or the equivalent in national currency. If the refund claim relates to a period of a calendar year or the remainder of a calendar year, the minimum amount claimable is €50, or the equivalent in national currency.

Claim restrictions

Partly exempt businesses must apply the appropriate recovery rate for each invoice or importation, and show the amount of VAT recoverable in the appropriate box. The recovery rate to be applied is the last percentage appropriate to the refund period covering the invoice date. For example, if the business's partial exemption overhead recovery rate in its March 2010 VAT return period is 10%, and the application is submitted in April before the annual adjustment is calculated, the claim should be restricted to 10%. However, if the business makes a claim after the annual adjustment has been made covering the March 2010 quarter, that recovery rate must be applied.

If the annual adjustment produces a different recovery rate from the rate used for the VAT return period when the claim was submitted, there is no need to amend the refund. Accordingly, it may be beneficial to delay submitting a claim until the year end if the annual adjustment is expected to provide a higher rate of recovery.

It should be noted that expenditure incurred in another Member State that relates to non-business activities is not claimable under the refund scheme.

Also Member States operate different restrictions for certain costs, which should be confirmed when entering the details on the online system.

Summary of expenditure codes

1. Fuel
2. Hiring of means of transport
3. Expenditure relating to means of transport
4. Road tolls and road user charge
5. Travel expenses, such as taxi fares, public transport fares
6. Accommodation
7. Food, drink and restaurant services
8. Admissions to fairs and exhibitions
9. Expenditure on luxuries, amusements and entertainment
10. Other

Time limits for making a claim

Properly completed claims must be submitted to the MSE no later than 30 September after the end of the calendar year in which the VAT was incurred.

The use of standard fields of information and expense codes will aid completion and are mandatory. Failure to include all standard information will result in rejection in the MSE. It is important to note that if a fully completed application is not received by the 30 September of the year following the refund period this will render it out of time.

Invoices required to be submitted electronically with the application

Member States can only require invoices with a value of €1,000 or more (€250 in the case of fuel), or the equivalent in national currency, to be scanned and submitted electronically with the application. For claims to the UK, HMRC requires scanned copies of invoices where the taxable net amount exceeds £750. All other invoices should be retained, as they may be requested at a later date by the MSR.

Key stages

Applicants will be informed at the following key stages of the process:

- when the MSE forwards the application to the MSR
- when the MSR receives the application
- if the MSR requires further information
- when the MSR makes its decision.

It is essential that the email address provided on the application is correct; if this changes at any time before the application is decided it must be amended at the earliest opportunity.

Method of payment

Payment will be made to the bank account detailed on the claim. Any bank transfer charges will be deducted by the MSR from the amount to be paid to the applicant.

If incorrect bank details are submitted by the business and this results in further bank charges being incurred, these may also be deducted from the amount payable on the current or a subsequent application.

Time limits for processing an application

The MSR must notify the applicant of its decision to approve or refuse the application within four months of the date it first received the application. If the MSR requires additional information in order to process the application, it can request this from the business, the business's tax authority, or a third party before the expiry of the four-month period. The additional information must be provided by the person to whom the request is made within one

month of receiving the request. Once the MSR has received the additional information it has two further months in which to notify its decision.

If further additional information is requested by the MSR the final deadline for making a decision can be extended up to a maximum of eight months from the date the application is received. Payment must be made within 10 working days following expiry of the appropriate decision deadline. It is hoped that this deadline will bring to an end the long delays, in many cases running into years, experienced under the previous paper system.

Summary of timetable of claims from the UK

- Submit claim by 30 September
- HMRC forwards claim to MSR within 15 calendar days of receipt
- Claimant receives notification when forwarded by MSE
- Claimant receives notification when received by MSR
- MSR has four months from receipt to approve claim or raise a query
- Business notified of result
- Payment must be made within ten workings days of approval
- If queried, claimant must reply within one month
- MSR approves or refuses claim within two months after query
- Or if no reply from the claimant, within three months
- Maximum limit is eight months
- If exceeded, assume claim has been rejected — consider appeal

Incorrect Application/Payment Errors

If a business discovers it has made an error on an application, a corrected application can be submitted. The correction procedure allows existing lines on the application to be amended or deleted (by reducing to 'nil') but does not allow new lines to be added. The correction procedure can also be used to amend incorrect bank details, email addresses, etc. If an application is found to be incorrect any overpayment will be recovered, normally by deducting it from any refund due. Also penalties and interest may be imposed and further refund applications suspended.

Refused Applications

If the MSR refuses an application fully or partly, it should also notify the applicant of the reasons for refusal. If this happens the applicant can appeal against the decision using the appeals procedure for that Member State. This means that the normal VAT appeals rules of that Member State on time limits, form of appeal, etc, will apply.

If the MSR has not notified its decision within the appropriate decision deadline, the applicant should consider that the claim has been rejected. The applicant's own VAT authority cannot intervene on its behalf.

Interest

Interest may be payable by the MSR to the applicant if payment is made after the final payment deadline set out above. If applicable, interest will be paid from the day following that deadline up to the date the refund is actually paid. Interest rates must be the same as those applied to refunds of VAT to taxable persons established in the MSR under the national law of that Member State.

If no interest is payable under national law in respect of refunds to established taxable persons, the interest payable will be equal to the interest or equivalent charge which is applied by that Member State in respect of late payments of VAT by taxable persons.

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In Conclusion

The new refund procedure certainly appears to be much more user-friendly than its predecessor and should provide more certainty and result in more timely repayments of VAT. In short it is to be hoped that it will be a vast improvement on the old system. Time will tell whether all the Member States have their systems in order and are ready to deal with, and answer any queries raised.

Article by John Rainsford and *Martin McQuillan - Tax Journal 18 January 2010*

New International services rules

This article reviews the current position on the changes to international supplies that are being implemented from 1 January 2010. The changes affect both services and goods, although the main effect is on services. The connected change to the 8th Directive reclaim system has been covered in an earlier month's update.

The changes represent the implementation of the "VAT Package", a number of related measures that have been planned for several years and which are intended to simplify international trade. These include:

- changes to the place of supply of services rules which are expected to reduce the number of occasions when a business in one member state has to charge their own state's VAT to foreign business customers;
- changes to the system for reclaiming VAT incurred in foreign states using the 8th VAT Directive.

The idea of these two changes is that there will be fewer occasions on which foreign VAT is incurred, but when it is, it will be easier to recover.

Balanced against those improvements, measures have been added to the VAT Package to combat missing trader inter-community fraud, also known as "carousel fraud". This generally involves a domestic supply by trader X, subject to VAT, followed by an inter-community supply by trader Y. Trader Y claims back the domestic VAT charged by trader X, but trader X has disappeared with the money and never accounts for it to the authorities. In order to make this more difficult, the new rules require more detailed reporting of inter-community transactions, and much faster filing of reports. This will be a serious challenge to anyone who sells goods or services to business customers elsewhere in the EU.

Changes to the law

The law has been amended by a Statutory Instrument which covers these rules and also the alteration to the flat rates used by small businesses. Amendments have been made to the relevant parts of SI 1995/2518 which deal with reporting, time of supply and 8th Directive reclaims. The Explanatory Note to the SI contains a great deal of information about the European background to the changes and the purpose of the various measures.

SI 2009/3241

Liability: goods

The changes on 1 January 2010 do not affect the VAT liabilities of people buying or selling goods internationally, or the conditions which must be satisfied to enjoy zero-rating of despatches and exports. It is only the reporting responsibilities of traders in goods that are affected.

Liability: services

The first important element of the VAT Package is a set of changes to the rules on "place of supply of services" for Business to Business (B2B) sales. These have previously been set out in s.7(10) and (11) VATA 1994, together with Sch. 5 VATA 1994 and SI 1992/3121 (the Place of Supply of Services Order).

With effect from 1 January 2010, all these provisions are repealed and replaced with new rules:

- s.7A VATA 1994 sets out the basic rules on place of supply;
- Sch.4A lists the various types of supply which are affected by different exceptions to the basic rules.

The three possible treatments for VAT on international services supplied by a UK trader are:

1. charge UK VAT, which the customer may be able to recover from HMRC;
2. register for VAT in another member state and charge VAT there;
3. charge no VAT, leaving the customer to account for VAT on a foreign VAT return (the "reverse charge" mechanism), subject to the rules in the customer's own country.

Of these, the ideal situation for both supplier and customer is the third. Strictly, such supplies are not "zero-rated" (as despatches and exports of goods are); they are "outside the scope of UK VAT" because the "place of supply" is outside the UK. The liability arises in the country in which the place of supply falls, and the customer is liable to pay the VAT in that country. The VAT Package is intended to increase the number of occasions on which the reverse charge (RC) is used and reduce the occasions on which either an 8th Directive reclaim (first possible treatment) or extra registration (second possible treatment) are required.

Up to 31 December 2009, the UK law on sales to foreign persons within the EU made the treatment dependent on whether the purchase was "for the purposes of a business carried on" by the customer. This meant that it was not enough to find out if the customer was VAT-registered: the supplier was also supposed to find out the use to which the customer put the supply. From 1 January 2010, the law will refer to the customer being a "relevant business person". This means someone who carries on a business activity anywhere in the world. If the customer is in business, the use to which the customer puts a supply of services will now be the customer's problem, not the supplier's.

In most intra-EU cases, the UK VAT treatment will depend on obtaining a valid VAT registration number for the customer with a two-letter country prefix. Although in the past it has been acceptable to obtain alternative evidence of business status and business use, the VRN will in future be required for reporting purposes, so it will be a good idea to obtain it to justify the treatment of the sale.

The following table sets out the main changes to the rules affecting supplies of services made by a UK business. It distinguishes between supplies to a "relevant business person" (B2B) and supplies to someone else, generally a consumer (B2C). The second table shows supplies that stay the same (although where the rules are has changed in all cases). It is not possible within this short summary of the most important points to give full definitions or explanations: please refer to the detailed guidance or the legislation for more information on any point which needs clarification.

Changes		***To 31 December 2009***	***From 1 January 2010***
Basic rule – if no exceptions apply	B2B	Where supplier belongs (UK VAT) – s.7(10) VATA 1994	Where customer belongs (reverse charge) – s.7A(2)(a) VATA 1994
Short-term hire of means of transport	B2B B2C	Where the supplier belongs (UK VAT) – s.7(10) VATA 1994 unless used and enjoyed outside the member states, in which case no VAT applies – SI 1992/3121 art.17	Where the vehicle is made available to the customer, unless used and enjoyed outside the member states, in which case no VAT applies – Sch.4A para.3

Long-term hire of means of transport (over 30 days for car hire)	B2B	Where the supplier belongs (UK VAT) – s.7(10) VATA 1994 unless used and enjoyed outside the member states, in which case no VAT applies – SI 1992/3121 art.17	Where customer belongs (reverse charge) – s.7A(2)(a) VATA 1994
Restaurant, catering in general	B2B B2C	Where supplier belongs (UK VAT) – s.7(10) VATA 1994	Where the services are physically carried out – Sch.4A para.5
Restaurant, catering on board EU transport	B2B B2C	Where supplier belongs (UK VAT) – s.7(10) VATA 1994	Where the journey departs from – Sch.4A para.6
Supplies of intermediaries	B2B	Where the main deal takes place – SI 1992/3121 art.13, unless the customer quotes a VRN to shift the place of supply/reverse charge – SI 1992/3121 art.14	Where customer belongs (reverse charge) – s.7A(2)(a) VATA 1994
Transport of goods within the EU	B2B	Where the transport begins – SI 1992/3121 art.10, unless the customer quotes a VRN to shift the place of supply/reverse charge – SI 1992/3121 art.14	Where customer belongs (reverse charge) – s.7A(2)(a) VATA 1994
Valuation of or carrying out of work on goods	B2B	Where the services are physically carried out – SI 1992/3121 art.15, unless the customer quotes a VRN to shift the place of supply/reverse charge – SI 1992/3121 art.14	Where customer belongs (reverse charge) – s.7A(2)(a) VATA 1994
Supplies of services formerly within Sch.5 VATA 1994*	B2B	If the customer belongs in another member state and uses the supply for the purposes of a business, outside the scope of UK VAT (reverse charge) – SI 1992/3121 art.16	Where customer belongs (reverse charge) as long as the customer is a "relevant business person", regardless of the use to which the supply is put – s.7A(2)(a) VATA 1994

* these include transfers and assignments of copyright, patents, licences, trademarks and similar rights; advertising services; services of consultants, engineers, consultancy bureaux, lawyers, accountants, and similar services, data processing and provision of information, other than any services relating to land; banking, financial and insurance services (including reinsurance), other than the provision of safe deposit facilities; the supply of staff; the letting on hire of goods other than means of transport; telecommunication services; radio and television broadcasting services; and electronically supplied services.

Significant categories of "basic rule services" which have previously been charged in the UK by UK suppliers even if the customer is a foreign business include:

- management services which do not fall within the "Sch.5 categories" listed above;
- call centre services which do not constitute advertising, the provision of information or financial services.

No change		***To 31 December 2009***	***From 1 January 2010***
Basic rule – if no exceptions apply	B2C	Where supplier belongs (UK VAT) – s.7(10) VATA 1994	Where supplier belongs (UK VAT) – s.7A(2)(b) VATA 1994
Long-term hire of means of transport (over 30 days for car hire)	B2C	Where the supplier belongs (UK VAT) – s.7(10) VATA 1994 unless used and enjoyed outside the member states, in which case no VAT applies – SI 1992/3121 art.17	Where the supplier belongs (UK VAT) – s.7A(2)(b) VATA 1994unless used and enjoyed outside the member states, in which case no VAT applies – Sch.4A para.3
Supplies relating to land	B2B B2C	Where the land is situated – SI 1992/3121 art.5	Where the land is situated – Sch.4A para.1
Supplies of passenger transport	B2B B2C	Where the transport takes place – SI 1992/3121 art.6	Where the transport takes place – Sch.4A para.2
Cultural, educational, entertainment services*	B2B B2C	Where the services are physically carried out – SI 1992/3121 art.15	Where the services are physically carried out – Sch.4A para.4
Hiring of goods	B2B B2C	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – SI 1992/3121 art.17	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – Sch.4A para.7
Telecommunications services	B2B B2C	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – SI 1992/3121 art.17	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – Sch.4A para.8
Electronically provided services (e.g. website supply, software)	B2B	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – SI 1992/3121 art.17	Where the rest of the rules would place the supply in the UK but the use and enjoyment is outside the EU, the supply is treated as outside the EU – Sch.4A para.9
Supplies of intermediaries	B2C	Where the main deal takes place – SI 1992/3121 art.13	Where the main deal takes place – Sch.4A para.10
Transport of goods within the EU	B2C	Where the transport begins – SI 1992/3121 art.10	Where the transport begins – Sch.4A para.12
Valuation of or carrying out of work on goods	B2C	Where the services are physically carried out – SI 1992/3121 art.15	Where the services are physically carried out – Sch.4A para.14
Supplies of services formerly within Sch.5 VATA 1994*	B2C	If the customer belongs outside the EU, outside the scope of UK VAT – SI 1992/3121 art.16	If the customer belongs outside the EU, outside the scope of UK VAT – Sch.4A para.16

* from 1 January 2010, most of these services will move to the reverse charge when supplied B2B; however, charges for admission to an event will continue to be charged where the event takes place.

A new version of the Place of Supply of Services Notice, now numbered 741A, has been issued to set out the rules from 1 January 2010 onwards.

Notice 741A

Reverse charges

For a UK business buying services from outside the UK (whether within the EU or not), the rules set out above will also determine whether the customer has to self-account for a reverse charge on the purchase of the services. The "basic rule" will now apply a reverse charge if none of the exceptions apply. Among the major categories of supply which are now automatically reverse charged if bought into the UK from outside are:

- management services;
- call centre services;
- long-term car leasing;
- all intermediary and transport services, and work on goods.

The option is preserved to allow a UK customer to account for a reverse charge as an alternative to the overseas supplier being required to register in the UK where:

- the place of supply is covered by Sch.4A Parts 1 and 2 (paras.1 – 9);
- the customer is already VAT-registered.

This is provided by s.8(2) VATA 1994. Where the place of supply is in the UK because of the new "basic rule" and the customer is not yet VAT-registered, the value of the reverse chargeable supply is included in the customer's turnover to determine whether the customer has a liability to register for VAT under Sch.1 VATA 1994.

Time of supply

The time of supply for international sales of services which are outside the scope has previously not been particularly important, because there was no liability to VAT and no specific reporting responsibility (although such sales were supposed to be included in Box 6 of the VAT return). For reverse charges, the rule in reg.82 SI 1995/2518 provided that the tax point was the date of payment.

Under the new regime, the time of supply becomes much more important, because it will be necessary to enter sales of services on an ESL. The time of supply for both sales (ESL) and purchases (reverse charge) will be the earlier of the completion of the service and the date on which it is paid for. Continuous supplies will be supplied at the end of each billing or payment period, or the date of payment if earlier. For continuous supplies that are not subject to billing or payment periods, the time of supply will be the end of the calendar year or the date of payment if earlier.

Paperwork: goods

The format of European Sales List or ESL for goods is not changing, but the frequency and deadlines are both being considerably tightened:

- monthly ESLs instead of quarterly reports will be required if the despatches of goods in the current quarter or any of the preceding four quarters exceeds £70,000;
- the first monthly ESL will be required as soon as the limit is exceeded, e.g. a trader who starts business on 1 January and makes £40,000 of despatches in January and the same in February must file an ESL covering January and February and will then file monthly ESLs from March onwards for at least the next year;
- the time limit for filing ESLs is reduced from 42 days from the end of the quarter to 14 days from the end of the relevant month (for paper returns) or 21 days (for electronic returns).

Clearly this is a tight time limit and traders need to make sure they are ready to meet it.

The transactions that have to be entered on the ESL do not change. ESLs include movements of own goods from the UK to a foreign branch; but they exclude distance sales, even if they are effectively treated as despatches to a foreign VAT registration of the same trader.

"Normal" despatches of goods will not require a special indicator on the ESL. "Triangular" sales of intermediaries which are disregarded using the simplification procedure under s.14(6) VATA 1994 are indicated by a code "2" on the ESL.

Zero-rated despatches are UK supplies, so they are entered in Box 6 of the return as well as in Box 8. A trader registered under the flat rate scheme has to account for flat rate VAT on despatches even though no VAT is charged to the customer – a considerable disadvantage of the FRS for such a trader.

Paperwork: services

The requirement to submit ESLs for services is completely new. The following points should be noted:

- only sales which are treated as outside the scope of UK VAT because the reverse charge will be applied by the customer should be shown on the ESL – it does not include exempt supplies or supplies which are sold to a foreign customer but charged to UK VAT;
- the ESL must show the value and the customer's VRN with two-digit country prefix;
- the services ESL is only required quarterly, but may be filed monthly if the trader wishes;
- the same time limits apply as for the goods ESL;
- supplies of services are indicated by a code "3";
- such supplies are supposed to be entered in Box 6 of the VAT return by a "normal" trader, but not by a flat rate trader (because no FRS VAT is due on such supplies);
- only supplies of goods are entered in Box 8 of the VAT return.

Article

There is a useful article on the change of rules in *Taxation*, 26 November 2009. Neil Warren uses a number of articles to highlight types of supply on which the place and liability change and on which they do not.

Taxation 26 November 2009

Lecture B579 (18.52 Minutes)

Lecture B580 (12.50 Minutes)