CONTENTS

The Chancellor has announced that the emergency Budget will be held on Tuesday 22 June.

Personal Tax

Impact of the state second pension on incorporation and remuneration levels

National insurance and entitlement to state pension

Employees pay Class 1 National Insurance while a sole trader or partner pay Class 2 and Class 4 contributions on their profits. By paying Class 1 contributions, an employee is given entitlement to both NIRP and S2P. According to Social Security Contributions and Benefits Act 1992 (SSCBA 1992), s 20 to s 21, Class 2 gives a sole trader entitlement to NIRP but not S2P. Class 4 NIC gives no entitlement to benefits whatsoever.

NIRP

From 6 April 2010, an individual requires 30 qualifying years to become entitled to the full NIRP, but where fewer years are held NIRP is given as one-thirtieth of the full rate for each qualifying year.

For there to be a ‘qualifying year’ for such benefits there must be earnings at least 52 times the lower earnings limit (LEL). For the 2010/11 year, this equates to an annual figure of £5,044 (see SSCBA 1992, s 122), with Class 2 contributions classed as meeting the LEL.

NIRP is flat rate rather than earnings related, with the maximum NIRP being £97.65 a week from 6 April 2010.

S2P

S2P is earnings related and there is no requirement for a minimum number of years’ contributions. It is only available through an employee’s Class 1 contributions and so it is not relevant for the self employed. Hence our interest when deciding whether to incorporate or not and having incorporated, whether we should be drawing salary or dividends.

Accumulating S2P entitlement

There are bands of earnings for accumulating S2P entitlement:

	BAND	***Accrual Rate for 2010/11***
LEL (£5,044) to LET (£14,100)	£9,056	40%
LET (£14,100) to UAP (£40,040)	£25,940	10%

S2P does not accrue for earnings below the LEL but once the LEL is met, the individual is treated as having earnings up to the low earnings threshold of £14,100 thus providing more generous benefits for the lower paid. It is then accrued at a different rate from the low earnings (and previously also the secondary earnings) thresholds, but is capped at the upper accruals point (UAP) of £40,040.

There are plans in the pipeline to change the 40% rate to a fixed £78 per annum soemtime before 2030 and then after 2030 to completely remove the accrual rate for those earning in excess of the LET.

How do the bands work?

For each year, a percentage of the earnings are taken by reference to the amount falling within each band for that year. That total figure is then averaged over the standard working life, typically 49 years i.e. ages 16 to 65 (but which will increase as the retirement age increases), to give the annual figure of S2P due for that one year’s contribution. The value for each year is then increased in line with national average earnings.

Example

Let's compare two earners, one on £45,000 per annum, and the other on £5,500. Both meet the LEL, but in the latter case without incurring an actual NIC cost that would be levied at the earnings threshold/primary threshold.

S2P entitlement on 1 year's earnings				
			£45,000	*£5,500*
LEL – LET	9,056	40%	3,622.40	3,622.40
UAP – LET	25,940	10%	2,594.00	
Accrued earnings			£6,216.40	£3,622.40
Annual pension	÷ 49		£126.86	£73.93
Lifetime gross income (19 years retirement)			£2,410	£1,405

We should also take into account that, even with unrestricted age-related personal allowances being at least £9,490, for many retirees the S2P income figure would be reduced by basic rate tax, when the £2,410 lifetime gain would be a net £1,928.

The impact of state pensions on incorporation

NIRB can be ignored as entitlement is the same whether employed or self employed but what is the impact of S2P?

Let's assume that we look at the standard tax-efficient salary/dividend mix: taking maximum remuneration out of the company with nil profits remaining; allocating £5,715 to salary so without incurring an NIC cost, and taking any balance as dividend.

	Profit levels		
	£20,000	£40,000	£60,000
Standard potential saving by incorporating	830	2,030	3,403
One year additional S2P - £74 19 years of retirement - net of BRIT 20% (74 x 19 x 80%)	1,124	1,124	1,124
Total one year benefit of incorporation	£1,954	£3,154	£4,527

When we rework the savings by factoring in future S2P pension earned on that low salary, accrued at 2010/11 rates, with this one year's S2P entitlement multiplied over a retirement lifetime, and assuming that basic rate tax is deducted on receipt there is an additonal saving by incorporating of £1,124per annum.

Low salary/high dividend?

Is the standard low salary/high dividend mix still the most efficient when we are considering the S2P entitlement?

Where earnings are within the 40% accrual band, £5,044 to £14,100, there is no further S2P gain – it is all treated as earned at the LET of £14,100 in any case – but there is substantial extra NIC cost.

Is it beneficial to increase the salary above the £14,100 LET and so into the 10% accrual band?

To measure the effect of S2P at any given salary level we can reflect the S2P accrual as a negative marginal tax rate. For the 10% accrual rate earnings band, this is about 3.87% of salary, being calculated as follows:

$$\left(10\% \text{ x } \frac{19}{49}\right) \text{ x } 100 = 3.87\%$$

If we adjust the marginal rates of tax on remuneration by deducting this 3.87% figure, it is not enough at any point to swing the balance towards paying salary rather than dividend.

The closest it gets is where a company is liable at the 29.75% marginal rate of corporation tax, when including S2P brings the marginal rate of tax on salary down from 38.83% to 34.96% – but which is still 5.21% more expensive than paying dividend.

So, advice on the salary/dividend mix is still status quo.

Summarised from an article by Rob Durrant-Walker writing in Taxation

Lecture B599 (17.34 Minutes)

How to report benefits provided by third parties

One difficult area with P11D work is the issue of benefits provided by someone other than the employer. These can easily be missed and need to be reported on form P11D by the employer in some, but not all situations. In some cases these are reported on form P35, and in some the provider of the benefit makes a report to HMRC.

When is a third party benefit taxable?

Benefits provided to an employee by someone other than the employer are taxable on the employee if they are provided by reason of the employment (S201 ITEPA 2003). Where the gift or benefit is provided in recognition of the job or services performed while doing the job, the benefit is taxable as if it were provided by the employer. So, for example, when an employee wins a prize sponsored by a supplier of the employer for selling on products supplied by that supplier, the prize is awarded in return for something the employee did as part of the duties of the employment, so the prize is taxable on the employee in the same way as if the employer provided it. Other examples include benefits provided to all employees of a certain employer – the benefits arise by reason of the employment so are taxable as a reward for employment. HMRC's guidance on "by reason of employment" in this context is in EIM 20503.

There is an exemption provided by S265 ITEPA 2003 for entertainment and hospitality provided as corporate hospitality. In this case, the person providing the benefit must not be the employer or anyone connected with the employer; the benefit must not have been procured by the employer or anyone connected, and the provision must not be in recognition of any past or future specific performance or action by the employee. So employees invited by a supplier to a hospitality box at Royal Ascot, or a Premier League football game will not normally be taxed on the benefit of this. HMRC's guidance on this area starts at EIM 21835.

Reporting by the employer

So far we have identified when a benefit is taxable on the employee, but there is a further condition to be met before the employer assumes responsibility for reporting the provision of the benefit on form P11D. The benefit is only reported by the employer when the employer arranged or facilitated the provision of the benefit. So, for example, an employer who arranges for several employees to be provided with a car by a motor dealership, as part of the sponsorship deal agreed between the employer (for example a county cricket club) and the dealership would be required to report the company cars on the P11D's prepared by the club – and indeed is liable for the Class 1A National Insurance Contributions on the benefit. Employers who merely provide a list of names to a third party are not regarded as having "arranged or facilitated" the provision of the benefit.

Reporting by the third party

A third party who makes expense payments or provides benefits to persons employed by another, is required to report the cash equivalents of such benefits and expense payments to the employee concerned, in writing by 6 July following the end of the fiscal year. No report is required to be provided to HMRC, unless the third party is required to do so by the issue of a return under S15(10) TMA 1970.

The information to the employees may be provided each time a benefit is provided, or at the end of the tax year on a total basis, and may be given direct to the employee, or sent either to his home or via the employer. Benefits and expenses which are exempt from tax when provided by the employer are similarly exempt when provided by a third party, and there is a further exemption in S324 ITEPA 2003 for small gifts costing less than £250 in a tax year.

Capturing the information

Firms undertaking P11D assignments are likely to have difficulty identifying benefits provided by third parties which need to be reported by their client. A real example might help members to identify likely candidates. A company instituted an incentive scheme for sales staff which was operated by an outside consultancy company using information provided by a senior sales manager. Sales staff were allocated points based on their sales mix for the month and when sufficient points had been accumulated, could surrender these for prizes, which were supplied direct to them. The costs of operating the scheme and the prizes awarded were invoiced to the company as “Marketing services”, and the accounts department were not aware of the arrangements. The benefits were certainly provided by reason of the employment, and their provision was arranged by the employer, but unfortunately the company concerned did not report the benefits provided, and thus eventually came to HMRC’s notice, when a retrospective settlement was reached for the four years that the scheme had been operated. So it is worth phrasing questions very carefully and thinking about those clients who are particularly sales driven when undertaking P11D assignments.

Contributed by Rebecca Benneyworth

Lecture B598 (8.08 Minutes)

Mobiles phones – have you checked the contract?

It is always important to ascertain who has taken out the contract with the mobile phone provider.

Although the bill may show the company name and address, the contract may be a personal one between the individual and the provider which is being sent to the employer for payment.

Where directors and employees have taken out contracts personally, if the employer refunds the costs, this is the settlement of a personal liability of the employee by the employer and is no longer treated in the same way as an employer-provided mobile or PDA.

HMRC guidance can be found in CWG2 *Employer Further Guide to PAYE and NICs* chapter 5.

The costs should be included in earnings for National Insurance. If the employer reimburses the employee, the payment should be included as earnings for tax and included on the P11.

If the employer pays the supplier direct the amount is included on the P11D rather than P11.

Taxline May 2010, Contribution by Angela Williams

When is an employee’s mobile phone not tax-free?

The answer, according to HMRC, is when it is a Personal Digital Assistant (PDA) such as a Blackberry or device with similar functionality. This could be an important distinction when employers complete P11Ds, although in practice most employees should still not be taxed on their employer-provided PDA.

Since 6 April 2006, for new mobiles provided to an employee, the definition of 'mobile telephone' in s 319, Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) has been 'apparatus designed … for the primary purpose of transmitting and receiving spoken messages'.

As PDAs also include computer functions they are not considered to be a mobile phone for these purposes.

The exemption from tax under s 319, ITEPA 2003 for a single mobile provided to an employee does not therefore extend to PDAs, which are taxed in the same way as computers.

However, provided that the PDA is solely for business use and any private use is 'not significant', the provision of the PDA will be exempt under s 316, ITEPA 2003.

'Not significant' is not defined in legislation but guidance is given in the *Employment Income Manual* at EIM21613.

In the more unusual situation where an employee is provided with two handsets, employers need to take care that P11Ds are completed correctly. If one handset is used solely for business (or private use is insignificant) and the other has both business and private use (or wholly private use), the distinction between PDA and standard mobile will be important. If both handsets are mobiles, there should be no tax charge. This is because the handset used mainly for private purposes can be exempt under s 319, ITEPA 2003 and the other, being for business use only, is exempt under s 316, ITEPA 2003.

However, if two PDAs are provided, the s 319, ITEPA 2003 exemption does not apply so only the PDA used solely for business will be tax-free and the cost to the employer (including rental, call charges, insurance, VAT etc) of the provision of the PDA which has private use will be taxable and should be included on the P11D.

Furthermore, if both handsets have significant private use, both will give rise to a taxable benefit. The moral here is that it is more tax-efficient for the employee if: 1. the employer does not provide two PDAs but rather one mobile and one PDA or two mobiles; and 2. any private use of a PDA needs to be 'not significant' to avoid a tax charge.

HMRC provides useful guidance on this issue in Chapter 22 of Booklet 480 *Expenses and Benefits, A Tax*

Guide and in EIM21778-21781.

Taxline, May 2010, Contribution by Angela Williams

Charities – changes made by Finance Act 2010

The Finance Act 2010 received Royal Assent on 9 April 2010. This includes three Schedules which affects charities, many of which expressed concern that the measures would be enacted with no effective scrutiny by Parliament, given the very short time allowed to debate the Bill. In outline, the measures are as follows :

Schedule 6

Schedule 6 introduces a new definition of a charity for tax purposes, covering both unincorporated charities and charitable companies. The change largely takes effect from 6 April 2010. The definition has been expended to include charities in the EEA as well as those in the UK, and replaces the definitions previously in use.

The definition is based on a company or body of persons meeting various conditions, which are :

- It is established for charitable purposes only – as described by the Charities Act 2006, irrespective of where the charity is established
- It meets the jurisdiction condition – that is the UK or any other member state, and is subject to the control of the relevant Courts in that jurisdiction

- It meets the registration condition – it has met any requirements applicable to it in section 3 of the Charities Act 1993 or equivalent legislation in other member states, and
- It meets the management condition – the managers (the persons having general control and administration of the body or trust) are fit and proper persons.

HMRC are given power to publish the names and addresses of bodies meeting the requirements for tax purposes, and the definition is effective for the following taxes :

- Income tax
- Capital gains tax
- Corporation tax
- VAT
- Inheritance tax
- SDLT, stamp duty and stamp duty reserve tax

Schedule 7

This schedule makes changes to the rules regarding the donation of listed investments to charity in response to a number of schemes which have been intended to exploit this legislation. Frequently shares are issued at a low cost to investors, which shares then acquire a significant value on overseas stock markets. The shares are then donated to charity, with the loss against market value then claimed for relief by the donor. The shares are ultimately sold by the charity for no more than their issue price.

The changes to the relief prevent this from working by requiring that where the relevant shares have been held for less than 4 years and were acquired as part of a tax avoidance scheme, the shares are valued at the lower of market value and acquisition cost – the cost being reduced by any monies paid to the taxpayer under the terms of the scheme.

The changes take effect for donations made on or after 15 December 2009. The following examples of how the new rules work were included in the Explanatory notes to the Finance Bill (note that this was originally moved as Schedule 8)

Example 1

Mr Jones enters into an agreement with Company X to buy £200,000 of shares in a FTSE 100 company from Company X for £30,000. The shares come with an option attached for Company X to buy them back after three years for £1.

Two days after purchasing the shares Mr Jones donates them to Charity B and claims under section 431 of ITA that this is a donation of £200,000 – the market value of the shares. He claims that the fact that the option to buy the shares back for £1 exists is not taken into account in valuing the shares because the option is a contingent liability which is ignored under section 440(2)(b) of ITA.

However new section 437(1A), (1B) & (1C) of ITA will apply because the shares were acquired within four years of the date of disposal and the reason Mr Jones purchased them was so he could donate them to Charity B and claim tax relief. As the cost of buying the shares was only £30,000, compared to their market value of £200,000, Mr Jones is only entitled to relief of £30,000 under section 431 of ITA.

Example 2

Mr Blake is a successful IT entrepreneur who buys a controlling stake in a small listed IT company in 2009 for £5 million. He has seen an opportunity to turn the company round and make a significant profit on his investment. He is successful and by 2011 the company is thriving and his shares are now worth £25 million.

In 2012 Mr Blake visits a hospice to see an old friend and is so impressed by what he sees he decides to donate £1 million of those company shares to the charity that runs the hospice to pay for a new treatment room and some equipment they need.

Although Mr Blake has donated shares to a charity less than four years after he purchased those shares, new section 437(1B) of ITA does not apply as when he purchased those shares in 2009 the main purpose, or one of the main purposes, of making that acquisition was not to obtain tax relief by donating the shares to a charity.

Example 3

Miss Smith inherited 10,000 shares in a listed company from her father in 1982.

In 2010 she decides to donate half the shares to a local animal shelter which is run by a charity. At the time of the donation the 10,000 shares are worth £80,000 so her donation is worth £40,000. Miss Smith is entitled to relief on £40,000 under section 431 of ITA. The shares were acquired by her over four years ago so the new provisions do not apply.

Even if Miss Smith had inherited the shares in 2008 the new provisions would not apply as although the gap between acquisition and donation is less than four years, the shares were not acquired by her in circumstances where the main purpose, or one of the main purposes, of that acquisition was to obtain tax relief by donating those shares to a charity.

Example 4

Mrs Jackson lives in a small village in Suffolk and farms a 1,000 acre arable farm around the local village. A fellow farmer decides to sell 10 acres of land on the edge of the village next to the village hall. The village hall (a charity) would like to acquire two acres for a sports field but don't have sufficient funds.

Mrs Jackson agrees to buy the 10 acres for £40,000 (market value) and then donates two acres of the land to the village hall and claims the tax relief available. She keeps the remaining eight acres and incorporates the land into her farm.

Mrs Jackson only purchased the land so she could donate the two acres to the village hall. She did not particularly need another eight acres for her farm, although she will use it to grow wheat.

Mrs Jackson can claim relief under section 431 of ITA for the two acres donated to the charity. New section 437(1B) of ITA will apply because the land has been purchased and donated within four years and was purchased so she could donate the two acres to the village hall and claim the tax relief available. Therefore the amount of relief is limited under new section 438A of ITA to a "just and reasonable" apportionment of the acquisition cost of £40,000. Given 2/10ths of the land has been donated then a similar proportion of the acquisition costs would qualify for relief - £8,000.

If the situation had been a little more complex, say half of the 10 acres had just been re-zoned by the local Council for housing and so the cost of the 10 acre parcel was £5 million, then in apportioning how much of the £5 million relates to the two acres given to the village hall would be more complex. For example if the two acres were not within the re-zoned area the cost would probably still be £8,000 as the vast majority of the £5 million cost will relate to the five acres which can now have housing built on it. Such a case may require valuations to be agreed with HM Revenue & Customs to determine the amount of relief due under section 431 of ITA.

Schedule 8

This Schedule makes various amendments to charity tax law :

Paragraph 1 implements a tax charge on charities which receive donations through the payroll giving scheme. The donations are then exempt from tax based on the application of the funds for charitable purposes only. It is likely that this was an omission in the existing legislation as the new rules merely replicate the existing provisions affecting both trusts (in ITA 2007) and companies (in CTA 2010).

A slight change to the rules on overseas donations provides that to qualify as charitable expenditure a charity must show that any claim that a payment overseas is supported by evidence sufficient to satisfy the Commissioners for HMRC that the charity's trustees took reasonable steps to ensure the money would be spent charitably. In practice that means charities will be required to maintain records of how charitable funds are spent overseas and be able to produce evidence of charitable works undertaken. The level of recordkeeping required will depend upon the circumstances relating to the expenditure. For example, it may not be possible for a charity providing aid during an emergency to maintain the same level of record-keeping as for routine overseas expenditure.

Paragraph 3 aligns the treatment of UK and non UK donors who pay insufficient tax to cover the tax relief on their donation. Previously, gifts from non UK donors would not qualify as gift aid at all if the donor paid insufficient tax to cover the tax retained on the gift. The new legislation ensures that non UK donors assume the liability for the tax shortfall themselves, and not the charity recipient.

Finally, paragraphs 4 to 7 make some administrative changes to the gift aid reclaim process.

Contributed by Rebecca Benneyworth

Lecture B596 (10.17 Minutes)

Capital Gains Tax

Action to consider before the 22 June Emergency Budget

Clients should consider creating a disposal before 22 June in case CGT rates are increased in line with the Coalition Government agreement as follows:

"We further agree to seek a detailed agreement on taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities".

The same statement was included in the Queen's Speech on the opening of Parliament, but with the word "closer" replacing "close". Whether or not that subtle change has any significance remains to be seen, and there is also the issue of a campaign being waged to try and stop any major increase in the rate of CGT applying to non-business assets.

If a chargeable asset is owned which has a pregnant gain, consider the following - with particular attractions where the asset was intended to be sold later this year in any event:

ASSET	POSSIBLE ACTION
Property	Transfer to limited company or trust
Quoted shares	Sell. Can buy back if desired, after 30 days. Or immediate repurchase by spouse/civil partner or own ISA
Unquoted shares in trading company	No action unless gain over £2 million
Unquoted shares in other company	Transfer to limited company or trust

Issues to consider

There a number of issues to take into account in making a decision to create a disposal before 22 June:

1. Stamp duty is payable on property (this is 4% on property worth over £500,000; 3% over £250,000 to £500,000; 1% over £150,000 (£125,000 if residential property) to £250,000.
2. Possible reduction in CGT annual exemption from the current level of £10,100, which may be worth trying to utilise before 22 June.
3. The big question is from what date will any CGT increase take effect - that could be 6 April 2011; 22 June 2010; or perhaps 6 April 2010?

If the trust route is used, rather than a transfer to a limited company, that will create an IHT liability at 20% on the excess of the market value over the nil-rate band of £325,000.

Article contributed by Gerry Hart

Lecture P596 (9.08 Minutes)

Negligible value claim (the Harper case)

The recent case of *Harper v HMRC (2009)* concerned a claim for negligible value relief under S24(2) TCGA 1992. It related to shares in a trading company called HMS President (1918) Ltd. In order for the relief to be claimable, the shares must become of negligible value. Where the value of shares at the time of their allotment is already negligible, they do not 'become' of negligible value and so the relief is not available. Note that the term 'negligible value' is not defined in TCGA 1992.

However, in Para CG13124 of the Capital Gains Manual, HMRC take the view that it means 'worth next to nothing'.

Mr Harper had made a S24(2) TCGA 1992 claim which he then wished to set against his income tax liability under S574 ICTA 1988 (see now Ss131 and 132 ITA 2007). This was refused by HMRC. They argued that, at the time when the shares in HMS President (1918) Ltd were acquired by the taxpayer, they were already of negligible value and that relief was not therefore available.

The First-Tier Tribunal held that the net asset position of the company at the time of the allotment was likely to have been negative (remarkably, they did not see proper sets of company accounts and, in particular, no balance sheets!). They went on to say that the burden of showing an entitlement to claim the relief lies with the taxpayer. Since he had not provided evidence that the shares had any value when they were subscribed for (despite the substantial sums which he had paid), he was unable to demonstrate that the shares had become of negligible value and consequently his case failed.

Contributed by Robert Jamieson

Lecture P597 (8.09 Minutes)

Barnett v Revenue and Customs Comrs

The appellant and his siblings jointly owned a property which was professionally valued, in 1998, at £150,000. In 2005 they sold the property for £249,000. In his self-assessment tax return for the tax year 2005–06 the appellant returned a chargeable gain of £50,000 (ie one-third of the £150,000). In 2007 HMRC opened an enquiry into that return, taking the view that the valuation was incorrect. The appellant appealed. The parties subsequently agreed a downward adjustment in the value of the property, which was valued at £123,730, and also agreed the amount of capital gains tax payable, ie £41,250 (one-third of the lower valuation). The appellant then sought to reduce that gain to zero, on the basis that he wanted to sell some shares which would result in a loss; and that he should be allowed to set off the resultant loss against the chargeable gain which he had accrued in the previous tax year. HMRC refused on the basis that under TCGA 1992 s 2(3), such a loss could not be set against a chargeable gain accruing in an earlier year. The appellant contended (i) that the refusal was unfair and unreasonable, and contrary to HMRC's assurances in public notices that they would act fairly and reasonably, (ii) he had acted carefully at all stages in the matter, in reliance on a professional valuation obtained from a responsible valuer; and (iii) had he known of the additional liability at a time when he could have reduced it by making a timely loss-making disposal, he would have done so. However he had not known of that additional liability until several years after the disposal had been made.

The tribunal considered that it was unable to take into account a loss on a disposal of assets which had not been made. Any such loss was at that stage hypothetical. Furthermore on the facts there was no basis on which the tribunal could properly allow an appeal against the amendment to the appellant's self-assessment for 2005–06. The amendment was agreed to be correct, because it was calculated on the basis of the agreed acquisition cost of £41,250. Moreover, the tribunal had no jurisdiction to deal with general complaints that the HMRC had treated a taxpayer unfairly or unreasonably and there was nothing to suggest that any such complaints should be upheld. It followed that the appeal would be dismissed.

Appeal dismissed.

Tribunal: John Walters QC and Gill Hunter, 21 January 2010

Company purchase of own shares

Ordinarily this would constitute a distribution equal to the difference between the proceeds and the original subscription price. The shareholder then pays income tax at a maximum rate which is effectively 36.1% of the "profit" for those with taxable income of at least £150,000 and that of course includes the gross equivalent of the distribution.

CGT treatment will usually create a lower tax liability, and with full entrepreneurs' relief the maximum tax is 10% of the first £2 million of gain (18% thereafter). To qualify for CGT treatment all of the following conditions have to be met:

- purchase is wholly or mainly for the benefit of the trade
- purchase is not part of a scheme to enable owner to participate in profits without receiving a dividend, or to avoid tax
- vendor UK resident and ordinarily resident in tax year of purchase
- shares owned for at least five years (reduced to three years if inherited, and the deceased's ownership period can also be added)
- vendor not connected with company immediately after the purchase; this involves not holding over 30% of issued ordinary share capital or of loan capital and issued share capital or of voting power, and in practice this means careful consideration of the position of associates which for this purpose excludes children (unless minors); brothers; sisters

Advance clearance is available under Section 225 TA1988, and at the same time Section 701 ITA2007 clearance should be sought under the transactions in securities anti-avoidance provisions.

The benefit of the trade test should be satisfied in any of the following circumstances:

- buying out a dissenting shareholder
- a controlling shareholder retires to make way for new management
- a shareholder who provided equity finance wants to withdraw the finance
- a shareholder dies and the new owner of the shares does not wish to keep them

HMRC's comments on this are in *IRSP 2/82* and *Tax Bulletin 21*. Relevant points from these and other more recent sources include:

- Retention of a small sentimental stake is acceptable (say maximum of 5%). Although technically CGT treatment is available where the vendor is only substantially reducing his shareholding (so that he holds not more than 75% of the proportion he held immediately before the buy back), in many situations this would result in the trade benefit test not being met.
- Vendor could have a short-term consultancy with the company to ensure a smooth handover. HMRC nowadays seem to accept that staying on as a part-time employee does not mean that the "benefit of the trade" test is failed.
- All the requirements of the Companies Acts must be met. The prohibition on a private company providing financial assistance for such an acquisition no longer applies. There is also no longer any requirement for a company to have authorisation in its articles for a buy-back of its own shares, but the articles can prohibit or restrict it.
- The vendor could lend back some of the proceeds, but then the 30% connected persons formula may be a problem in which case a bonus issue could be made as a means of increasing the issued share capital before the buy back
- Another possible solution, where the full proceeds cannot be paid in one go, is for the company to buy back the shares in stages, but then the trade benefit test may not be met. The alternatives are:
    1. A single unconditional contract with successive tranches of the shares being sold on specified dates. State how many shares are initially being sold, and how many are to be sold at a later specified date. The later sale is subject to the 30% test but the proceeds of that later sale do not form part of the loan capital test, as per *Tax Bulletin Issue 21*. The vendor retains voting rights until completion date and the proceeds have been paid. The 30% test therefore applies to the shares but not to the proceeds.
    2. Two or more separate purchases are made because of the company's cash-flow position. Payment is made in full on the contract dates. The 30% test therefore applies to the shares only.

3. A single unconditional contract is entered into, with multiple completion dates. The beneficial ownership of the shares passes at the date of the contract but the CGT liability may be payable earlier than would otherwise be the case and this could be before all the consideration has been received. In this arrangement, the vendor would agree to waive any rights to dividends etc from the date of the contract. A clearance application would be made under Section 225 TA1988 by reference to the single disposal.

- Company law requires all of the consideration on a buy-back to be paid when due, with nothing left outstanding. HMRC accepts that where consideration is deferred under the terms of the contract until completion date, this requirement is met.

Contributed by Gerry Hart

Inheritance Tax and Trusts

IHT and the Balfour case

Judgment in *Brander v HMRC (2009)* was delivered by the First-Tier Tribunal last year. The decision, which went in favour of the taxpayer, provides valuable guidance on the availability of business property relief for traditional landed estates, confirming that a significant amount of letting income will not necessarily jeopardise a business property relief claim, provided that 'the preponderance of activity and effort' in the management of the estate lies in trading activities. It should be noted, however, that HMRC have announced that they are appealing the Tribunal's ruling.

The facts

The 4th Earl of Balfour became the liferenter of the Whittingehame Estate in East Lothian on the death of his father in 1968 ('liferenter' is the Scottish term for a life tenant). The estate extended to over 1,900 acres, including two in-hand farms, three let farms, a number of houses and cottages which were mainly let on short assured tenancies, two sets of business premises, parks, woodlands and forestry. There were also valuable sporting rights.

Prior to 2002, Lord Balfour had operated the in-hand farming business (known as the Whittingehame Farming Company) either as a sole trader or in partnership. The operations of this business on the one hand and the trustees' business on the other, which mainly consisted of the lettings on the estate, were separately registered for VAT purposes and also had separate accounting and invoicing arrangements.

However, in November 2002, the trustees transferred the estate to Lord Balfour outright. Three months later, Lord Balfour entered into a partnership with his nephew and heir (Michael Brander), but he died shortly afterwards in June 2003.

In 2008, HMRC issued a notice listing a number of reasons why, in their opinion, the estate did not qualify for business property relief. In particular, they argued that, because Lord Balfour had entered into the partnership arrangement with his nephew less than two years before his death, the relevant ownership tests had not been satisfied (see Ss106 and 107 IHTA 1984). The other issue under dispute was whether the estate had been run as a single business by Lord Balfour before his death or whether there had been two businesses: one run by Lord Balfour and the other by the trustees. If there was a single business, the question then arose as to whether, in view of the letting income, the estate consisted wholly or mainly of the making or holding of investments, which would of course preclude the availability of business property relief.

The judgment

The Tribunal held that Lord Balfour had run the estate for his own benefit, for the preservation of the estate and for his future heirs and they felt that, regardless of the administrative and accounting arrangements, he had managed it as a single business. They said:

'To that end, he used assets of the trust estate in the business activities being carried on at Whittingehame. He took de facto responsibility for running all aspects of the estate. He either made the business decisions himself or made recommendations to the trustees which he expected them to approve and they invariably did so. The trustees rarely met and appeared to be entirely passive. The trust solicitors appear to have dealt mainly with Lord Balfour on estate matters. This is all consistent with Lord Balfour running the business as a whole.'

They went on to observe that, throughout the relevant period, Lord Balfour had either been the liferenter carrying on the business as a sole trader or in partnership. Overall, they were content that there was a single business (notwithstanding the fact that the trust was a separate entity), that Lord Balfour's interest in the partnership with his nephew had replaced the previous business carried on by him and that the business property relief ownership test had therefore been satisfied.

Turning to the issue of whether the single business consisted wholly or mainly of making or holding investments, they considered where the preponderance of business activity was. With reference to the approaches taken in *Farmer v CIR (1999)* and *CIR v George (2004)*, they confirmed that the business activities needed to be looked at in the round and that there were several relevant factors involved in creating the overall picture, including turnover, profit, expenditure and time spent by everyone in the carrying on of the various activities. On the facts, they thought that the letting side at Whittingehame was ancillary to the farming, forestry, woodland and sporting activities and that the farming enterprise, albeit that it included agricultural tenancies, occupied the greater area of the estate. The judge summed up the position with the following striking comment:

'My impression is that the management of a landed estate such as Whittingehame Estate, even where a significant amount of the income is derived from letting income, is overall mainly a trading activity. That is where the preponderance of activity and effort lies.'

In light of this, he held that the business activities carried on did not consist wholly or mainly of making or holding investments and that business property relief was available for the whole.

Conclusions

There seems little doubt that this will be an important case for landowners. The judge made some encouraging comments, not least when he stated that any suggestion that the activities being carried on at Whittingehame involved the making or holding of investments was 'to belittle the efforts required properly and profitably to manage the various components of an estate of this nature'.

However, given HMRC's appeal of the Tribunal's ruling and given that the authorities are generally examining business property relief claims much more closely these days, it is essential that landowners take steps to ensure that they present the strongest possible case. In particular, the following matters need to be considered:

The owner should ensure that he has a single management structure with accounts covering the entire estate business rather than having separate accounts for each estate department.

The owner should not employ staff just to look after the lettings– they should be involved in the trading elements of the business as well, eg. the farming, forestry and sporting activities.

Where possible, the owner should aim to increase trading activity on the estate by making, for example, cottages available as holiday lets rather than on assured shorthold tenancies.

Assets which are obviously investments should be ring-fenced and transferred to separate trusts.

Information should be gathered from comparable cases, particularly within the same locality, which could be submitted by way of supporting evidence in a claim for business property relief.

Contributed by Robert Jamieson

Lecture P598 (13.30 Minutes)

Perpetuities and Accumulations Act 2009

On 5 January 2010, Parliament confirmed that the Perpetuities And Accumulations Act 2009 will come into force on 6 April 2010.

The principal impact of this important piece of new legislation is that all trusts executed on or after 6 April 2010 will have a perpetuity period of 125 years (as opposed to the current maximum of 80 years). The accumulation period, at present limited to 21 years, will also be increased to 125 years. This will avoid the situation where income has to be distributed to immature or inappropriate beneficiaries rather than being accumulated with capital. A shorter perpetuity and accumulation period can still be chosen, if thought fitting.

The relevant periods for trusts already in existence are unchanged. There is a provision in the legislation, however, which allows trustees to execute a deed extending the perpetuity period to 100 years where there is uncertainty as to when the period in the trust deed will come to an end – this will typically involve cases where the perpetuity period is defined by reference to 'lives in being'.

The extension of the perpetuity and accumulation periods for UK trusts will undoubtedly make the UK a more favourable trust location than hitherto. However, even these extended periods are more limited than the position in many offshore jurisdictions where perpetuity periods have been abolished in their entirety, effectively allowing assets to be tied up in trust indefinitely.

Contributed by Robert Jamieson

Lecture P599 (3.48 Minutes)

Pitt and another v Holt and another, Chancery Division

The first claimant's husband was awarded damages in respect of injuries he suffered from a car accident. As receiver for her husband, the first claimant put the money in a settlement.

After her husband's unexpected death, HMRC said that the form of the settlement meant that inheritance tax was due on the creation of the settlement, on subsequent capital distributions, after ten years, and on the husband's death.

The first claimant and her advisers had not considered the inheritance tax position when setting up the trust; had they done so and realised the impact the tax would have on the value of the damages, they would have created a different kind of settlement to avoid the problem.

Therefore, the first claimant asked to have the settlement unravelled, invoking the *Hastings-Bass* principle (see *Re Hastings-Bass deceased* [1974] STC 211).

The judge in the High Court agreed that the *Hastings-Bass* principle applied in the circumstances. It was obvious that anyone thinking about setting up a discretionary settlement should take the various tax consequences into account.

As a result of not having done so, the amount of damages had been seriously reduced by a large and wholly unnecessary tax bill.

There was no doubt that if the first claimant had been aware of the potential inheritance tax charges, she would not have entered into the settlement , but clearly neither she nor her advisers had given any thought to inheritance tax.

The settlement should be set aside.

The application was allowed.

Administration

The Coalition joint programme for government

In his address to the CBI annual dinner on 19 May, The Chancellor of the Exchequer said that the forthcoming Budget would contain a "five-year road map for a big reform of corporation tax".

The Chancellor restated the Conservative manifesto pledge to reform the controlled foreign companies rules, as part of an overall plan to simplify the corporation tax system and reduce rates. Aiming to encourage multinational firms to come to the UK, the manifesto spoke of "moving towards a territorial corporate tax system that only taxes profits generated in the UK".

The full coalition agreement, *The Coalition: our programme for government*, is now available from the Cabinet Office website at www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf.

Proposals for business include:

- We will review IR 35, as part of a wholesale review of all small business taxation, and seek to replace it with simpler measures that prevent tax avoidance but do not place undue administrative burdens or uncertainty on the self-employed, or restrict labour market flexibility.
- We will reform the corporate tax system by simplifying reliefs and allowances, and tackling avoidance, in order to reduce headline rates. Our aim is to create the most competitive corporate tax regime in the G20, while protecting manufacturing industries.
- We will consider the implementation of the Dyson Review to make the UK the leading hi-tech exporter in Europe, and refocus the research and development tax credit on hi-tech companies, small firms and start-ups.

The proposals for taxation read as follows:

- We will increase the personal allowance for income tax to help lower and middle income earners. We will announce in the first Budget a substantial increase in the personal allowance from April 2011, with the benefits focused on those with lower and middle incomes. This will be funded with the money that would have been used to pay for the increase in employee National Insurance thresholds proposed by the Conservative Party, as well as revenues from increases in Capital Gains Tax rates for non-business assets as described below. The increase in employer National Insurance thresholds proposed by the Conservatives will go ahead in order to stop the planned jobs tax.
- We will further increase the personal allowance to £10,000, making real terms steps each year towards meeting this as a longer-term policy objective. We will prioritise this over other tax cuts, including cuts to Inheritance Tax.
- We will also ensure that provision is made for Liberal Democrat MPs to abstain on budget resolutions to introduce transferable tax allowances for married couples without prejudice to the coalition agreement.
- We will reform the taxation of air travel by switching from a per-passenger to a per-plane duty, and will ensure that a proportion of any increased revenues over time will be used to help fund increases in the personal allowance.
- We will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities.
- We will make every effort to tackle tax avoidance, including detailed development of Liberal Democrat proposals.
- We will increase the proportion of tax revenue accounted for by environmental taxes.

- We will take measures to fulfil our EU treaty obligations in regard to the taxation of holiday letting that do not penalise UK-based businesses.
- We will review the taxation of non-domiciled individuals.

Quasi-Legal General, 20/05/2010

Tax enquiries update

There is a new era involving tax enquiries (or compliance checks as HMRC prefer to call them). They basically involve shorter and focussed enquiries all with the aim of reducing time and resources for all concerned. Our job as tax agent is to make sure that individual officers do not attempt to take advantage of the new era so as to obtain extra tax when none is in fact due.

New initiatives

HMRC have a number of initiatives, already underway or planned for introduction later this year, to make compliance checks less costly and stressful for businesses:

High Volume Intervention. This deals with small and isolated mistakes requiring simple correction, by processing the errors quickly by letter or telephone without access to business records or a visit to business premises.

External Communication. HMRC are redrafting many of their letter templates to use clearer language and explanations, a neutral tone and a more logical structure. The new letters are easier to understand and so help to reduce customer uncertainty and the level of support businesses need to comply with HMRC requests.

Openness and Early Dialogue principles. HMRC aim to talk to businesses at the start of a compliance check, explain why they are checking and what that check will involve. By building an open and collaborative relationship in this way, checks can be concluded sooner with reduced costs for the customer.

Compliance Process Re-engineering. HMRC are undertaking structured reviews of the traditional methods of carrying out compliance checks with the aim of cutting out waste. A review of Employer Compliance processes has been completed and pilot activity is being analysed, prior to adoption. VAT and Income Tax Self Assessment re-engineering is underway.

Informal tax enquiries

The legislation to back-up the new approach is in Schedules 36 & 37 FA2008, taking effect from 1 April 2009. Schedule 37 covers record-keeping and for direct tax it largely amends TMA 1970 (particularly Section 12B). However, one must always be aware that paragraph 21 of Schedule 36 states that a request for information by reference to a tax return submitted to HMRC can only be made if a formal enquiry is opened – unless there is a suspicion of a loss of tax arising. Non-statutory checks may not always be the best way forward for the client.

Reports and issues on this include:

- HMRC seem to use informal routes first and only go down the formal route if the former has not worked.
- Will tax enquiry insurance pay out where information has been given to HMRC outside a formal framework?
- Without a formal notice can an agent be subject to litigation on the grounds that he passed information to HMRC without any legal obligation to do so?
- The need for a much clearer route map so that all parties understand what form of intervention is appropriate and in what circumstances.

Is the new era good news?

Summary of the points to take on board:

1. The even greater need to explain any unusual business statistics in terms of pattern of expenditure claimed, ideally by including a brief business profile in the tax return. The tax office receiving the figures is likely to be miles away so the officer will not have any

understanding of the local business environment which may be a factor when the officer analyses the results.

2. If a tax return is selected for enquiry, push for an explanation of what HMRC are apparently unhappy about – even if the *openness and early dialogue* approach is not being used.
3. Educate clients to ensure they are not regarded as high-risk under the new era.
4. Spell out to clients the advantages of not being high-risk; in particular that they will not have to face mandatory visits to their premises.
5. Is there any role left to play for random enquiries?

HMRC's risk assessment

Their procedures, which have been criticised by the Commons Public Accounts Committee in the past, have supposedly been improved in recent times. Risk Intelligence and Analysis Teams (RIAT) use confidential methods, some of which have been divulged following a formal request under the Freedom of Information Act.

Aspects to appreciate include:

1. RIAT identify risks for all sizes of business, based on the following:
    - Use of 3-line accounts where by definition there is no analysis of expenses claimed.
    - High and incorrect expenses claimed.
    - No private use adjustments.
    - Incorrect loss claim.
    - Low means.
2. The general principles adopted by the Large Business Sector are likely to be extended to SMEs as well. This in particular involves HMRC assessing the taxpayer as low risk or non-low risk. The former status should result in HMRC trusting the figures filed based on effective and reliable systems and processes being in place.
3. HMRC's assessment of the business starts with a business risk review. This uses a template which aims to identify tax risks and prompts HMRC to gain an understanding of the business, key systems and processes.
4. HMRC then uses seven headings under which it determines the following:
    - Complexity of the business (including size, financing, degree of change)
    - Approach to compliance (including general governance, tax strategy, ability to pay the right tax at the right time)
    - The resultant business risk review tax risk rating, for discussion with the taxpayer

Source material

There is no shortage of useful material to assist you. It includes the following:

- HMRC Enquiry Manual
- HMRC Regulation of Investigatory Powers Manual
- HMRC Business Income Manual
- HMRC Compliance Manual
- Business Economic Notes
- Compliance checks leaflets CC/FS1 to FS13
- Working Together newsletter
- Tax investigation books from tax publishers

Article contributed by Gerry Hart

Lecture P600 (10.37 Minutes)

HMRC enquiries and Tribunals – what to do now

As well as detailing the department's aims for the year, HMRC Business Plan 2010-11 mentions two points:

- "Ensure those seeking to evade tax are subject to robust and effective civil and criminal action".
- Tackle avoidance risks through policy and legislative design, designing out opportunities for avoidance and continuing to develop principles-based legislation which strengthens defences against innovative avoidance schemes. Where avoidance does occur, we will detect it early and tackle it through effective legislative change and/or well-targeted challenge, litigating where necessary."

Tackling non-compliance and eliminating tax evasion has long been an objective for HMRC. The last HMRC Performance Report dated December 2009 puts the tax take from self-assessment business and non-business enquiries at over half a billion pounds for 2008-2009, by no means a negligible figure, and eradicating tax evasion is set to remain a priority as the government continues to look for ways to maximise tax receipts in a difficult economic environment.

From evasion to avoidance: A shift in focus

There have been some notable shifts in HMRC rhetoric and policies on tax enquiries. The first is well illustrated by the 2010-11 departmental goals. Whilst efforts to identify and tackle unlawful tax evasion are only to be expected, HMRC is now talking of a crackdown on tax avoidance. Tax avoidance, as opposed to evasion, is of course legal in the UK and its status has been confirmed in case law on several occasions. Tax practitioners will be familiar, for instance, with the Ramsay v IRC (1981) case, where Lord Wilberforce re-iterated that taxpayers were permitted to structure their financial affairs in such a way as to reduce their tax liabilities.

However, a crackdown on tax avoidance has been highlighted as a target in political manifestos and identified as one of HMRC's priorities over the coming months. This leads us to a key question, given that taxpayers are permitted to structure their affairs so as to minimise tax liabilities where possible and tax professionals may advise them in that respect, when could such advice be seen as a case of tax avoidance that must be disclosed to HMRC? When does normal tax planning become a reportable 'scheme'? Reporting requirements are becoming increasingly stringent; Alistair Darling's last Budget in April 2010 announced legislation to bring forward the time when disclosure of schemes must be made to HMRC and extend the 'hallmarks' of a tax avoidance scheme.

It is interesting to note that on a number of occasions over the past year, tax evasion has been addressed through amnesties whereby tax evaders can come forward voluntarily, declare any unreported income and regularise their financial affairs in exchange for lower penalties. We have seen the New Disclosure Opportunity allowing those with undeclared offshore funds to come clean to HMRC, then the Tax Health Plan that extended a similar offer to medical and dental professionals. All those with undeclared funds who chose not to take up opportunities offered by the amnesties have been threatened with investigation as HMRC gains access to an ever-increasing volume of data under tax information exchange agreements signed with different countries; so we can expect a raft of investigations where tax inspectors suspect possible undeclared funds.

It remains to be seen how HMRC will handle these investigations given that the department is still seriously under-resourced and the situation is unlikely to be remedied soon given the new government's emphasis on cuts in public spending. Over the years, HMRC has been notoriously unwilling to initiate criminal prosecutions given that the process can be both costly and messy. The squeeze on resources highlights the fact that voluntary cooperation benefits both sides – the taxpayer can expect a more lenient treatment if they come forward to regularise their affairs voluntarily and HMRC would be keen to avoid the burden of a protracted investigation.

What will happen?

We can expect a slew of enquiries launched in the weeks and months to come as HMRC steps up efforts to eradicate tax evasion and, in a newer development, pays increasingly close attention to potential instances of tax avoidance too. So what should be done when faced with a letter from HMRC announcing an enquiry into an individual's or a business' tax affairs?

First and foremost, the response to that initial letter will be crucial. It will have to very carefully considered and as comprehensive as possible, since this first response will determine whether the initial enquiry is continued by HMRC as a full-scale investigation. If the enquiry does blossom into a fully-fledged investigation, the key factor to bear in mind is, again, that honesty is always the best policy. Where HMRC uncover evidence of wilful evasion, penalties can now be as high as 200% of unpaid tax, so anyone who may have unpaid tax would be well advised to make a prompt, full and complete disclosure.

Ronnie Ludwig, Saffery Champness writing in AccountingWeb, 20 May 2010

Reasonable excuse

The recent cases of *The Research & Development Partnership Ltd v HMRC (2009)* and *Huntley Solutions Ltd v HMRC (2009)* provide an interesting contrast in the meaning of what constitutes a 'reasonable excuse'. Both cases were heard by the same First-Tier Tribunal on the same day and both were concerned with the imposition of a penalty for failure to comply with HMRC notices requiring the production of documents and information. Both taxpayers relied on the same accountant to deal with the provision of the information. The accountant was overwhelmed with work and had failed to produce the relevant documentation.

The taxpayers claimed that the fault was that of the accountant on whom they had relied to satisfy the HMRC notices and so the default of the accountant, they claimed, represented a reasonable excuse as far as the two companies were concerned.

The Tribunal agreed that reliance on a third party is capable of being a reasonable excuse, but this depends on the particular tasks involved. In the first of the two cases, the taxpayer was required to produce a detailed statement of its research and development tax relief claim with reference to the legislation. The relevant legislation was not straightforward or easily understood by those not generally acquainted with tax law and so it was right and proper for the company to rely on its accountants to provide the information. This was a reasonable excuse and the penalty should not have been imposed.

In the *Huntley Solutions Ltd* case, the arguments and the reasoning were identical. However, in this instance, the Tribunal found that the information and documents required from the company were straightforward and easily understood. It was not reasonable for the company to rely on its accountants to provide this information when it could easily have complied with the notices themselves. Accordingly, the company did not have a reasonable excuse and the penalties remained chargeable.

It is interesting to compare these cases with the earlier decision in *Adams v HMRC (2009)* when the Tribunal said that the taxpayer was not guilty of negligent conduct as he was fully entitled to rely on his professional advisers (who had made a mistake). The Tribunal concluded that, when it was clear that Mr Adams had relied for advice from his tax agents, any allegation of negligence against him personally should have been withdrawn. What amounts to a reasonable excuse and what amounts to negligence are of course entirely different things, but this more sympathetic approach to the difficulties faced by taxpayers is clearly to be welcomed.

Contributed by Robert Jamieson

Lecture B597 (5.33 Minutes)

Law Society intervenes in Prudential appeal case

The Court of Appeal has given the Law Society of England & Wales permission to intervene in a crucial court case in which Prudential is seeking to extend legal professional privilege (LPP) beyond the legal profession.

The Society has permission to intervene in the appeal of *Prudential PLC and Prudential (Gibraltar) Limited v Special Commissioner of Income Tax and Philip Pandolfo (HM Inspector of Taxes)* over concerns about the potential scope for any professional giving advice on an area of the law to claim LPP. This would be irrespective of whether they are regulated or members of any organised and disciplined association and irrespective of their role in the administration of justice.

LPP gives communications between a lawyer and his/her client for the purpose of obtaining legal advice privileged status so that such communications cannot be made available to the court or third parties.

Law Society President Robert Heslett says:

"The case has the potential consequence of giving anyone who describes his/her self as a tax accountant or other professional the ability to withhold vital information from bodies such as HMRC, when legal professional privilege is intended to have a very specific purpose. The boundaries of LPP must remain clear. Extending it risks creating uncertainty over what can and cannot fall under LPP.

"The concept of legal professional privilege has been and remains closely tied to the administration of justice. The first duty of a solicitor is to the Court and the second is to the client. In this respect a solicitor is unique among the professions. The duty to the Court seeks to ensure that the privilege is not abused.

"In consequence the courts have taken the approach that legal advice privilege does not attach solely because of the purpose and nature of the advice but also because the advice emanates from a member of the legal profession."

The Prudential case concerns the advice provided by accountants where litigation was not contemplated. In such scenarios the advice and any information in relation to it will not benefit from legal advice privilege and a taxpayer may have to disclose documents or information, including its communications with the accountant under Schedule 36 Finance Act 2008 and section 20 Taxes Management Act 1970.

The Society points out that in October last year the High Court held that legal advice privilege does not extend to advice from, and communications with, accountants even if it relates to advice about the law.

Law Society President, Robert Heslett, says:

"The Society believes that the issues raised in this appeal are of considerable importance both to the solicitors' profession and the public interest. Questions which bear upon the nature and extent of legal professional privilege are fundamental to the work of solicitors.

"An extension of legal professional privilege to non-lawyers is not a new suggestion. It is something which has been considered by law reformers before, but has never been taken up by Parliament. Such an extension should be the subject of consideration by Parliament and, if considered desirable, be the subject of primary legislation which would clearly define the limits and conditions of any extension to other professionals."

Julian Copeman and Heather Gething, partners in Herbert Smith LLP, are instructed by the Law Society in connection with the intervention. Hebert Smith commented that, "Privilege is the creation of the common law and as it stands the common law is clear: only communications with a lawyer are protected by privilege. Any extension would seem to us to require statutory intervention."

In-house lawyers

The Society has also been tackling the issue of legal professional privilege on behalf of its in-house members' interests. While the Society was refused permission to intervene in the Akzo Nobel case in the European Court of Justice, it continues to lobby hard to ensure certain communications between in-house lawyers in their capacity as solicitors and their company executives remain subject to privilege.

Last week, the Advocate General's opinion on the case favoured not allowing privilege for general counsel.

Law Society Chief Executive Desmond Hudson says:

“We are disappointed with the opinion given by the Advocate General but we must wait for the European Court of Justice to give its ruling on this issue and we remain hopeful. For our part, a solicitor is a solicitor whether working in practice or as General Counsel for a company. Their obligations as an officer of the court and as a member of a fine profession remain unchanged.”

Law Society of England and Wales. 6 May 2010

Poopalasingham v Revenue and Customs Comrs (No 2)

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. HMRC also reviewed the appellant's business records. The appellant agreed to an invigilation period where he knew test purchases by HMRC would be made. Two test purchases were made in that period but the subsequent investigation of till rolls showed that only one had been recorded. It was also noted that recorded takings had substantially increased when compared to the turnover shown in the tax returns. The officer was of the view that, on the basis of the available evidence, at least £700 of income had been suppressed each week. HMRC amended the appellant's tax return for the years ended 5 April 2005 and 5 April 2006. HMRC also issued assessments for the years ended 5 April 2003 and 5 April 2004 under the discovery provisions in TMA 1970 s 29. The appellant appealed. The tribunal heard the appeal in the appellant's absence and the appeal was dismissed (see [2009] UKFTT 282 (TC), [2010] SWTI 91). However, following a successful application by the appellant to set aside that decision the appeal was reheard.

The tribunal found that the estimates of income made by HMRC were on the facts fair and were reasonably based on the information before them. The onus was on the appellant to show otherwise, and he had not done so. He was could give no credible reasons nor produce any evidence as to why £150 per week would be a better estimate of the suppressed income. Nor did he challenge in any meaningful way the officer's analysis or her estimates of the business income. It followed that the appeal would be dismissed.

Appeal dismissed.

Tribunal: Nicholas Aleksander (Judge) and MM Hossain, 22 January 2010

Vinton and ors v Fladgate Fielder (a firm) and anor [2010] EWHC 904 (Ch)

WAL Ltd (WAL) was a company in the ownership of the D-C family, in which shares were held by the late Mr D-C's executors (his daughters, the first and second claimants), and his widow, the testatrix. The first claimant also held shares personally. At that time, the testatrix was the sole surviving director. She had an outstanding loan due from WAL to her of £300,000. The first defendant solicitor firm (the firm) had acted as the family solicitors for the D-C family for many years. Between October 2002 and December 2002, the first and second claimants and the firm agreed that the testatrix's loan would be converted into equity with the advantage that, whereas the loan would be valued in her estate at £300,000, shares in WAL would be subject to business property relief (BPR), so there would be an inheritance tax saving. The requisite paperwork for a rights issue of 999,733 shares of £1 each was prepared, and the testatrix was allotted 300,000 shares which she took up her allotment in satisfaction of her loan account (the rights issue shares). The first and second claimants took up the allotment of 202,465 shares to which the estate of the late Mr D-C was entitled. The first claimant did not take up any of the 497,268 shares that were allotted to her under the rights issue, and the firm prepared a letter of renunciation in favour of the testatrix (the renunciation shares), which the testatrix took up using funds from her free estate. It was subsequently decided to raise a further £1m for WAL. The first defendant prepared the paperwork to achieve that but on that occasion it did not utilise the mechanism of a rights issue, but proceeded by way of an offer of shares for subscription. The testatrix subscribed for all of the shares on offer (the subscription shares), paying for them using £1m from her free estate, on the footing that they would attract BPR, consequently attracting inheritance tax relief. Two days later, the testatrix died, having appointed the first and second claimants, her nephew, L, and one of the first defendant's partner's as her executors. Under the terms of her will, a residuary trust fund was constituted, divided into ten parts, being held in trust for the first and second claimants and their children. Following her death, it was discovered that BPR was not available in relation to most of the shares which she had acquired under the rights issue and the offer for subscription. Normally, business property had to be retained for two years before it qualified for relief. However, if the shares owned by the testatrix could be identified with other shares previously owned by her, and those previously owned shares had been held for two years, then all of the shares qualified. That condition was only satifsied in relation to the rights issue shares 300,000 shares (on the basis that she had acquired them in the right of her ownership of a holding of 750,000 shares), but was not satisfied in relation to the renunciation shares, and the subscription shares, on the basis that those shares had been acquired by her for reasons unconnected with her existing holding, they had been simply bought. The first and second claimants unsuccessfully appealed against the Revenue and Customs Commissioners' analysis of the position. On 3 December 2008, the first and second claimants, L, and the other beneficiaries commenced proceedings against the first defendant and its limited liability partnership, seeking to recover damages to compensate them for the sum chargeable as inheritance tax upon the shares acquired by the testatrix in respect of which no BPR was available. The defendants applied for orders striking out the claimants' statement of claim pursuant to r 3.4(2)(a) of the Civil Procedure Rules (CPR), and alternatively, for summary judgment pursuant to CPR 24.2.

The first defendant submitted that the claimants' statement of case disclosed no reasonable grounds for bringing the claim, and alternatively, that there was no real prospect of their succeeding on the claim, and there was no other compelling reason why the case should be disposed of at trial.

The court ruled:

(1) In respect of the contract claims, there was a serious claim for breach of contract. In respect of the tort claims, following the guidance in established authority and applying those tests, it was not appropriate in the instant case to strike out the claim.

Accordingly, the claims would not be struck out.

(2) Having considered the particulars of claim, the terms of the defence and the evidence filed on both sides, the first defendant had failed to discharge the burden upon it to demonstrate that the claim was fanciful.

The application for summary judgment would be dismissed.

Chancery Division Norris J 30 April 2010

Business Tax

Should a dental practice incorporate?

An interesting thread was posted on Taxation in recent weeks....

"I have one or two dental practices as clients. One dentist has recently come to see me saying that he has heard that another firm of accountants is suggesting that dentists really should incorporate their practices. I get the impression that this is 'flavour of the month'.

Obviously, I don't want to lose my clients and have decided to look into this in more detail and wonder if readers can provide any additional information as to whether this is a good thing or not.

This particular client is, in fact, only a few years away from retirement; will this make incorporation more or less beneficial?

Also, if the business does incorporate, is there any compunction for the dentist to take a salary rather than dividends or allowing the profits to roll up?

I would be interested to hear whether fellow *Taxation* readers are having this experience and what approaches they take."

Query 17,599 – Tooth Fairy

Reply from S.G.

Prior to July 2006, it was not possible for dental practices to incorporate, except for a very small number of companies that were in existence prior to the introduction of the rules preventing incorporation in 1955.

The Dentist Act 1984 (Amendment) Order SI 2005 No 2011 repealed section 42 of the Dentists Act 1984, which prevented incorporation and allowed for the first time individual dental practices to form limited companies.

Those corporate practices in existence since before 1955 had been able to expand and run multiple practices and have grown into very large organisations that provide dental services nationwide. The amendment order was introduced to bring more competition to the profession.

The change in the law has brought opportunities, but there are still restrictions to ensure the quality of dental services does not suffer.

At least 50% of the directors of a dental limited company should be dental professionals registered on the list of dental care professionals kept by the General Dental Council.

There are several tax advantages associated with incorporation. An optimal remuneration strategy for the dentist principals would be to pay salary up to the earnings threshold for National Insurance purposes and then pay the balance of remuneration as dividends.

In addition, there is a significant tax advantage to be had by the principals selling goodwill to the limited company; with the consideration being left outstanding on directors' loan account for future tax-free extraction.

This essentially locks in a capital gain on incorporation, but at the favourable 10% rate as entrepreneurs' relief will apply.

Depending on the date that the goodwill was first purchased or generated by the dentist, there may be an annual amortisation amount allowed against the company profits. Such a deduction would not be available to sole traders or partnerships.

As dentist practice values can be quite high and the resultant tax savings considerable it is advisable to get a professional valuation done by a specialist dental valuer.

In my experience, when using the post-transaction clearance mechanism available under the CG34 route, HMRC Shares Valuation Department often go into the complex detail of how exactly a value for goodwill was arrived at.

While accountants typically may have a go themselves at putting a value on a small/medium-sized enterprise (SME) business, for dental practices it is paramount to use the services of an expert.

For a dentist a few years from retirement, as is the case with Tooth Fairy's client, the transfer of goodwill to a limited company may provide an opportunity for savings, in that the amount that the goodwill can currently be sold to the company for may be in excess of the amount that the goodwill will ultimately be sold to a third party for.

In addition, the annual draw down against the director's loan account may prevent the dentist from paying higher rate tax again in his career.

Incorporation brings with it of course the familiar disadvantages, such as having to file abbreviated accounts with Companies House each year and extra administration for dividend paperwork and annual returns.

In addition both corporation tax and income tax returns would need to be prepared as well as full statutory limited company accounts to satisfy HMRC requirements.

To date, incorporation of practices with high levels of NHS earnings have been largely avoided as there is still uncertainty as to how to treat the superannuation deductions (pension contributions into the NHS pension scheme) that are taken from the practice income, and also how to account for the superannuation that should be paid over on the salary and dividends taken from the company.

Another problem with incorporation and the NHS is that in order to increase their funds for NHS services, a number of primary care trusts (PCTs) have been eager to take back smaller exempt NHS contracts from predominantly private practices, and have been looking for opportunities to do this.

One of the ways they have been doing this is to treat any variation in a contract as a reason to cancel or renegotiate the contract.

A variation can occur when a practice requests the transfer of a contract from the names of the partners to the name of the incorporated practice.

However, practices have incorporated and retained their contract by incorporating the practice, but leaving the contract in the name of the dentist(s) and subcontracting the work under the contract to their company, similar to the way they would utilise the services of an associate dentist.

In summary then, yes there are potentially significant tax savings to be made on incorporating a dental practice, but these need to be considered alongside commercial factors such as an unfavourable outcome from contract renegotiations and the uncertainty surrounding superannuation contributions.

Reply from The Snark

There are so many issues to be addressed in a question like this that one can only scratch the surface in a Readers' Forum response. One must assume a reasonable knowledge of the mechanics of incorporating a business.

Many medical practitioners, not just dentists, are actively considering incorporation. The rationale ultimately is that they do not want to pay income tax at 50%, but is that achievable? As Tooth Fairy suggests, it might just be flavour of the month.

Historically, dentists were not allowed to offer their services via a limited liability body owing to the restriction in Dentists Act 1984, s 42. Existing dental companies were a curious exception dating from before the foundation of the National Health Service (NHS).

The rules changed on 31 July 2006 when the restrictions in the Dentists' Act were lifted. Even so, General Dental Council approval will need to be obtained before the business can be transferred to a company.

The starting point is that dental profits will attract a marginal rate of 41% (40% income tax plus 1% National Insurance contributions or 51% if they exceed £150,000 in 2010/11. One must not forget the loss of personal allowance as well which gives an effective income tax rate in the band £100,000 – 112,950 of 60%.

For a sole practitioner, an equivalent company is likely to pay corporation tax at 21%. That looks quite a saving. If we are considering a partnership, the profits could soon creep into the marginal corporation tax band with an effective rate of 29.75%. However, that is not the end of the story.

In my experience, dentists not only have the capacity to earn large sums but they soon spend them too. If the money is to be withdrawn from the company one must look at the overall effective rate, taking the company and the individual together.

For a small company and a 40% director/shareholder, the combined rate is: salary 47.7%, dividend 40.75% (50% recipient, salary 56.6%, dividend 49.5%). Not a huge saving on the dividend, and salary actually makes things worse. The real advantage with dividends comes in the basic rate band where the effective rate for the individual is 0%.

There is probably a temptation to introduce other family members, especially non-working spouses, into the company structure. This might have short-term tax advantages, but a new Government might revisit possible income-shifting rules to counter the benefits obtained by Geoff and Diana Jones, in the case known colloquially as *Arctic Systems* ([2007] STC 1536).

Only if significant profits can be stored in the company can there be any advantage. Tooth Fairy says that one of his clients is close to retirement. Could this dentist minimise his drawings, cease in practice and then liquidate the company?

This gives access to a capital gains tax rate of 18% (overall effective rate of 35.2%) or better if entrepreneurs' relief is available. However, I would not like to gamble on the capital gains tax rate remaining this low for much longer.

What Tooth Fairy needs to think about more carefully is the nature of his client's business. Is it a NHS practice or private or a bit of both?

If it is wholly or substantially a NHS practice, it will operate under a contract with the local primary care trust (PCT). This contract is personal to the dentist. It is not transferable.

A company could apply for one as a successor, but there is no guarantee that it would get one, especially on similar terms to the sole trader/partnership. The PCTs are being stricter on this and there is at least a perception that they are making it harder to incorporate where the underlying reason is a saving of tax.

I have heard it said that the existing contract could be subcontracted, but that is only possible if the existing holder is incapable of doing the work. The PCT is unlikely to agree to subcontract to a wholly-owned company.

Even if there is a valid subcontract, the professional liability remains with the holder of the contract (which could double the insurance costs).

Burrells Accountancy Ltd make another valid point in Feedback. The NHS pension scheme is one of the best in existence. Incorporate the practice and take minimal salary to reduce tax liabilities and you risk losing substantial pension benefits.

If the practice is solely private or mixed, the private part could be incorporated. Apart from the pure income tax considerations, this opens the possibility of transferring goodwill to the company. If the whole business (or an identifiable part of it) is transferred to a company, with the goodwill, a capital gain will be realised.

There will be capital gains tax to pay at 18% (10% if entrepreneurs' relief is available). Payment would be by way of a credit balance on loan account with the company. As the company trades profitably, it is possible to draw down on the loan account without further tax liability.

This possibility assumes that the practice has goodwill and it is transferable. There probably is some goodwill inherent in the patient list but, for a sole practitioner, it must be personal and not transferable.

There might be a possibility of transfer with a larger, perhaps multi-branch, practice. I do not believe there is any goodwill at all in a NHS practice because of non-transferability of the contract.

Take these factors together and I am rather inclined to think that, in most cases, there is little or no monetary advantage in transferring a dentist's practice to a company.

Reply from Scorpio

The introduction of the 50% tax rate has generally increased the interest in incorporating businesses as this approach does provide various options for controlling the level of income which is being assessed to tax for each year.

This is not to say that taxpayers who will not have sufficient income to attract the 50% rate can also enjoy fairly substantial tax savings.

As Tooth Fairy's client is also fairly close to retirement, clearly this also has to be factored in to the considerations as to whether the business should be incorporated.

I do have a dental practice client who is seriously considering incorporating and this type of business would be able to enjoy significant tax savings over the next few years and would be looking to dispose of his shares to his existing associates over the next five years or so.

The mechanics of the exercise would be for a limited company to be set up and for the goodwill and some or all of the assets of the business to be disposed of to the company for market value.

The consideration for this disposal would remain as a directors' loan and would be available for the director to draw on as a supplement to salary and dividends. Part of the drawings from the company would be non-taxable and so it would be possible to control the level of taxable income while the loan account remains in credit.

There would, of course, be a disposal by the dentist of the goodwill and a personal liability to capital gains tax would arise, presumably this would attract full entrepreneurs' relief.

The capital gain cannot be held-over as the loan account balance represents consideration.

Consideration will need to be given to the valuation of goodwill and presumably this will be based upon a multiple of average profits over number of years.

It should also be noted that the company may also be able to claim the amortisation of goodwill in the future. This will depend upon whether it is pre- or post-April 2002 goodwill.

If properties are included within the balance sheet of the business, then detailed consideration will need to be given as to whether they should be transferred into the company or retained as personal assets by the dentist. The effects on business property relief for inheritance tax purposes and entrepreneurs' relief in the future will need to be considered.

I believe that the main consideration here will be the retirement of the dentist and whether he has any planned exit route set up. It can sometimes be difficult to dispose of the shares in a limited company and it would be more common for potential purchasers to want to purchase the assets of the business only.

This would mean that the company would be selling the assets and would pay corporation tax on any gain over the market value at the date of incorporation.

It would then be necessary for the dentist to extract the funds from the company and this would presumably involve the winding up of the company. Although in these circumstances entrepreneurs' relief would be available, the acquisition cost of the company's shares would be minimal.

If the dentist already has purchasers in mind, perhaps members of his family, it would be fairly easy to transfer or sell shares in the company.

As with all incorporations there are a number of non-tax issues that would need to be given consideration including whether incorporation is permissible by any governing bodies, changes in the name of any contracts in place, banking arrangements, VAT registration/transfer, etc.

In the first instance, I believe that Tooth Fairy will need to do some calculations highlighting the potential income tax/National Insurance contributions savings that can be achieved using different ratios of salary, dividend and loan account drawings. It should be highlighted that this will be an annual saving.

Tooth Fairy mentioned in his question whether a certain salary level should be needed. If there are pension premiums being paid personally then there would be a requirement for a certain level of salary, but other than that the position would be quite flexible.

As an option the company would be able to make employer pension contributions and this would not require any particular level of salary. Some form of pension planning would also need to be looked at, particularly in view of the restrictions in higher rate pension relief.

Tooth Fairy should also prepare some projected capital gains tax calculations; first to estimate the liability arising on incorporation and then to look at the possible position on retirement both as a sole practitioner and as a shareholder.

There will be two calculations needed for the shareholder route, one for the outright sale of shares and the other for the sale of assets by the company followed by the winding up of the company.

There is probably quite a bit of preparation for Tooth Fairy to do before he can present the options to his client, but it is important that the client is made aware of these possibilities at this stage.

A closer look... dentists and cessations and successions

The above query considers the pros and cons of a dental practice incorporating. It should of course be remembered that the incorporation will result in the cessation of the dentist's self-employment.

When advising their client on incorporation, the practitioner should not forget any adverse tax consequences of the cessation of self-employment such as an additional period's profits coming into charge, although this might be mitigated by overlap relief.

Furthermore, there may be non-tax related matters that will have to be considered such as the transfer of staff and their employment rights to the new company and possibly the transfer of leases or property.

Returning to the subject of cessations, HMRC's *Business Income Manual* at BIM54065 notes:

> 'The position of a dentist with a practice in a particular area is to be distinguished from that of a professional person who can exercise their professional skills anywhere in the country... Accordingly, if a principal dentist leaves a practice in one location and moves to a practice in another location, the income from both practices must be computed on cessation and commencement lines. The argument that a principal dentist carries on one continuous profession wherever they go should not be accepted where they operated in established practices'.

However, a distinction is drawn between a principal dentist and an associate who works for the principal and has no patients, etc. of their own.

HMRC state:

> 'They can make their services available to one or more principal dentists on terms which usually preclude them from retaining any of the patients as their own at the end of the engagement. In those circumstances... they are likely to carry on one continuous profession wherever they go. Accordingly, the cessation and commencement provisions should not be applied when they move from one associate position to another'.

But simply because a dentist is designated an 'associate' does not, of itself, mean that the above rules automatically apply and tax treatment will depend on the facts of each particular case.

Taxation, 19 May 2010

Gym membership

A reader of Taxation received the information below from a client.

The text that follows apparently represents the results of negotiations between HMRC's Divers Unit and the RMT, the National Union of Rail, Maritime and Transport Workers. The text is from the union representative.

> 'To all RMT Diving Members.
>
> 'An increasing number of diving members have asked me whether they can claim for the cost of going to the gym to keep fit for a diving medical and dental costs as good teeth are also required for the diving medical.
>
> 'Following discussions between the RMT and HMRC Divers Unit in Aberdeen as to whether the following expenses, "gym and dental" costs would be allowable for persons who undertake an annual HSE diving medical, both sides presented cases for and against the expenses being allowed against trade receipts. Claims for the cost of gym training (membership of a fitness or health club or use of such facilities) to keep fit for a diving medical and essential dental work to pass a diving medical, will be considered by HMRC Divers Unit in Aberdeen, subject to official receipts, in tax returns from 2009.

'The HMRC Divers Unit in Aberdeen have assured the RMT that each case will be looked at on its merits and that in the spirit of a compromise, claims of up to 50% from persons aged say 50 and on a sliding scale downward for younger divers would seem reasonable (e.g. 20% for age 20 to 30, 30% for age 30 to 40, 40% age 40 to 50 and 50% max from the age of 50).

'This is due to the duality of purpose of the "gym" expenses which excludes the entire cost being allowable as a revenue expense in that the cost is not wholly and exclusively for the purpose of the trade, but is incurred for more than one purpose and a deduction is only permitted "for an identifiable part or identifiable proportion" of the expense which is incurred "wholly and exclusively" for the purposes of the trade.

'On the question of dental fees, any fees designed specifically because of the conditions divers work under, the HMRC Divers Unit in Aberdeen would accept 100% claims. None of the fees for normal day-to-day dental treatment can be allowed. The evidence retained should show that the treatment was designed and specifically required for divers and diving work.

'Example 1

'Diver's gym fees per annum are £400, a 50-year-old diver could offset up to £200 saving £80 in tax if the 50-year-old is a 40% taxpayer (similarly £80 for age 20 to 30 saving £32, £120 for age 30 to 40 saving £48, £160 age 40 to 50 saving £64). What he is not allowed to claim for will be gym equipment for use in the home, as the wife or other persons can use it, or a week's stay at a health farm, as these are for your benefit not the trade.

'Example 2

'Diver requires essential dental work to pass a medical and you'll need a HSE doctor's certificate to state such work is required, at a cost of £200, he could offset up to £200, saving £80 in tax if he is a 40% taxpayer.

'What he is not allowed to claim for will be a general check-up, teeth cleaning or whitening, gold fillings, veneers or cosmetic work as these are for your benefit not the trade.'

Hopefully this information will be helpful to practitioners with divers as clients.

Stuart Carrington, Thomas Westcott, Taxation, 19 May 2010

The above also provides interesting possibilities for other clients with similar circumstances.

Icebreaker 1 LLP v Revenue and Customs Comrs

The limited liability partnership (I1) was formed in February 2004 with a view to conducting a trade of film distribution. On 5 April 2004 six individuals joined I1, contributing capital of £1,520,000 between them, of which 70% (£1,064,000) had been funded by non-recourse loans advanced by the Scottish bank ("the bank"). On its first day of trading, ie 5 April 2004, I1 made the following payments—(i) £46,950 to S for ten year licence rights over eight screenplays or equivalent rights—including the screenplay and other rights to a work "Young Alexander" ("YA") that was about to be filmed; (ii) £120,000 and £50,000 to IML as sums due under both an administrative agreement and an advisory agreement; (iii) £1,273,866 to C, as its head distributor, under a head distribution agreement ("HDA") in respect of the exploitation of the acquired licence rights. Under the HDA, I1 agreed to meet a proportion of the distribution and production costs and it also became entitled to various payments. The payments made by I1 to C were essentially of two categories—(a) "a final minimum sum" of £1,604,000 payable at the end of year ten, guaranteed by the bank; and ten annual payments ("annual advances"). Those payments were payable without any reference to whether there were any film distribution revenues or not; and (b) a proportion of distribution revenues, calculated on the basis that C would first retain 30% of such revenues and then—in the case of the YA film—I1 would receive 250/1,040 of the 70% balance until a total of £1,040,000 had been paid, and thereafter it would receive the fractionally greater amount of 25% of the 70% balance. In addition, C was required, under the HDA, to procure and provide security which was achieved by the bank providing an effective guarantee to I1, in form of a letter of credit, for C's payment of the certain payments. The bank's exposure under the letter of credit was itself secured by the bank taking a charge over the blocked deposit placed by C with the bank. Just before the payment of £1,273,866 was made to C, C modified the payment instructions to the bank and directed that £1,064,000 be paid to one account, which was effectively a blocked deposit account with the bank. The remainder, ie £209,866 was paid to a different C account with the bank, on which the monies were freely available to C. The total of all the payments made by I1 were virtually equal to its entire capital and resources and it immediately closed its accounting period on that day. In its partnership return for that one day accounting period, I1 claimed that virtually all of its expenditure contributed to a trading loss, and that its members could set the loss off against their other income for income tax purposes. HMRC opened an enquiry into that return and on 2 May 2007 issued a closure notice, reducing the claimed loss from £1,491,816 to £11,900. That calculation was based on disallowing the whole of the payment made to C; disallowing 30% of the total sum of £170,000 paid to IML, and allowing the balance, ie £119,000 but treating nine-tenths of it as a pre-payment; so that only one-tenth (namely £11,900) was allowed. I1 appealed and the issue arose as to the deductibility of the payments to C and IML.

The tribunal considered that where, as in the instant case, one payment was used to secure two or more quite distinct elements of consideration, it was appropriate to split the elements, and to address what services or rights and benefits each element of the payment secured. On the facts it was appropriate to deal separately with the £1,064,000 element of the payment to C. That payment had nothing to do with the trade for two reasons. Firstly, the payments were due, regardless of whether there were ever any film distribution receipts, and there was no relationship (in the sense of adjustment to payments, timing or source and funding for payments, or security for payments) between the rights to the “certain payments” and the possible receipt of film distribution income. All the parties knew with absolute certainty was that the deal being implemented on 5 April 2004 was one under which £1,064,000 had to be credited by C to the blocked account that delivered and secured the “certain payments”. It was of the essence of the transactions that the £1,064,000 would be placed in the blocked deposit account. That reinforced the conclusion that the payment of that element secured those very rights. It naturally followed that the £1,064,000 was not available to be spent on film production or distribution, even in the sense of C being able to use borrowed money for that purpose. Secondly, in determining the numerator in the fraction for dividing film distribution income, the £1,064,000 element had been excluded in fixing that numerator, thereby confirming that the £1,064,000 element had nothing to do with the production or distribution of YA. The only realistic construction of the real deal under the HDA was that £1,064,000 was paid to obtain and secure the rights to the certain payments. There was also the obvious point that all steps related to the £1,064,400 element were directed to achieving the tax advantage or ramping up ostensible expenses incurred on production and distribution. As all the parties knew that it was of the essence of the transactions that the £1,064,000 would be placed in the blocked deposit account, it was impossible to discern any non-tax effect that those steps and payments might have had. Furthermore, the only reason why the application of the £1,064,000 was significant in the present case was that the banking arrangements made it clear that the placing of the blocked deposit was the very way in which it was envisaged by all the parties that C would provide and secure the making of “certain payments” in return for the £1,046,000 received. The conclusion had to be that I1 was acquiring two distinct rights and making payments (rolled together to obfuscate matters) for those separate rights. The case then became one of an endeavour to ramp up the apparent expenditure for tax purposes, achieved by what could fairly be called “mislabelling”. Therefore the £1,064,000 was not deductible.

As regards the £209,866 element of the payment to C, the tribunal found that to the extent I1 was incurring expenditure on the production of the film, that expenditure was capital and to the extent it contributed to the costs of setting up distribution arrangements, that expenditure was revenue expenditure of its trade. On the facts, all but £35,000 of the £209,866 appeared to have been defrayed in meeting film production costs. Therefore £35,000 was income or revenue expenditure on arranging distribution, whilst the entire balance of £174,866 was capital expenditure incurred by I1 on the production of the master negative of a film. It was then deemed by F(No 2)A 1992 s 40A to be revenue expenditure; and finally required by s 40B to be allowed in periods falling after the period ended on 5 April 2004 so that no relief was available in respect of that amount of that period. The £35,000 was a prepayment made for film distribution purposes, none of which should be allowed in the period ending 5 April 2004.

As relation to the payments made to IML, (i) £51,000 (30%) out of the aggregate fee was a non-tax deductible cost of paying for the delivery of the I1 structure; (ii) £9,000 was allowable in the period ending 5 April 2004, as being referable to past services; and (iii) £29,000 was not in respect of past services, but a prepayment that should be allowed only in periods following the end of the 5 April 2004 period. It followed that the appeal would be allowed in part.

Appeal allowed in part.

Tribunal: Howard M Nowlan (Judge) and Nicholas Dee, 5 January 2010

Annual Investment allowance

The annual investment allowance (AIA) has been doubled to an annual spend of £100,000 per annum with effect from 1 April 2010 for corporation tax, and 6 April 2010 for income tax. The amendment was made by Section 5 of Finance Act 2010.

Businesses which have a year end other than 31 March or 5 April will have an allowance for the period of an amount spanning the date of change calculated by time apportioning the old and the new limits. There will be a further restriction that the amount of expenditure falling before the date of change cannot exceed £50,000.

Example

Able Limited has capital expenditure of £150,000 in the year ended 31 December 2010. The expenditure is main pool expenditure, and Able qualifies for AIA in full, having no related companies to take into account. The following computations will be needed :

- Calculate the annual investment allowance for the period; this is arrived at by time apportioning the £50,000 limit by the number of days in the accounting period before the change and the new £100,000 limit by the number of days falling after the change :

  £50,000 x 90/365 + £100,000 x 275/365 = £87,671

- The timing of the expenditure must now be examined :
  - No more than £50,000 of the total of £87,671 can be awarded against expenditure in the period 1 January 2010 to 31 March 2010.
  - The balance of any expenditure in that period will potentially qualify for first year allowances of 40% (subject to the conditions being met)
  - The remaining expenditure can qualify for AIA in the period 1 April 2010 to 31 December 2010, subject to the overall limit.

So if the expenditure was all incurred in the period between 1 January 2010 and 31 March 2010, the capital allowances would be :

- AIA of £50,000 (maximum amount prior to 1 April)
- FYA of 40% on the balance of £100,000 = £40,000 (assuming qualifying expenditure)
- Total £90,000

If the expenditure all fell in the period 1 April 2010 to 31 December 2010, the allowances would be :

- AIA of £87,671, and
- Writing down allowance of 20% on the balance of £62,329 (main pool expenditure) = £12,466
- Total £100,137

Finally, if the expenditure were incurred £75,000 in the period to 31 March and £75,000 in the following 9 months, the allowances would be as follows :

- AIA of £87,671 - £50,000 of which relates to the first tranche of expenditure
- FYA of 40% on the balance of pre 1 April expenditure of £25,000 = £10,000
- WDA of 20% on the balance of post 1 April expenditure of £37,329 = £7,466
- Total £105,137

The maximum allowances would be gained by incurring all of the expenditure before 1 April other than the amount needed to top the AIA up to the maximum. Thus incurring £112,329 prior to 1 April provides AIA of £50,000, and FYA of £24,932 on the balance of £62,329. Incurring a further

£37,671 after 1 April would attract a further AIA of £37,671, bringing the total allowances to £112,603.

Anti avoidance

There is also a new anti avoidance rule which prevents the sideways relief of losses in a rental business when the loss is related to AIA and "relevant tax planning arrangements" are in place. This applies to arrangements entered into on or after 24 March 2010. The provision is made by section 25 Finance Act 2010. For this purpose, relevant tax planning arrangements means that the main purpose or one of the main purposes of the arrangements is being in a position to make use of the AIA in the obtaining of a reduction in tax liability by means of property loss relief against general income.

This rule could affect those investing in commercial property who incur expenditure on fixtures which could attract AIA. This could also affect those with Furnished Holiday letting activities, as in view of the survival of that regime through the legislation terminating the regime being dropped from the Finance Act 2010, AIA would still be available on them. Sideways relief for losses incurred would therefore need to satisfy this anti avoidance test in relation to expenditure incurred on or after 24 March 2010.

Contributed by Rebecca Benneyworth

Accounts provisions

For some years now HMRC has employed qualified accountants to help it identify errors in accounts that may lead to deficiencies in a business's tax liability.

The case of Leslie Smith v HMRC TC00403 illustrates how HMRC can collect large sums of tax by questioning the accounting treatment.

Leslie Smith is a successful sub-contractor in the construction industry who undertakes ground works in large value contracts for major building companies.

The essence of this case was whether the valuations of stock and work in progress included in Mr Smith's accounts from 1995 to 2002 were correct. Due to the nature of Mr Smith's work large contracts were incomplete over the year-end and had not been billed for. The value of those incomplete contracts would normally be treated as work in progress.

Leslie Smith appointed chartered accountant Mr Tidbury to prepare his accounts over many years. Unfortunately for Mr Tidbury both members of the Tax Tribunal were also chartered accountants, and they were not impressed with Mr Tidbury's evidence. This could be due to Mr Tidbury's statement that he did not generally include any figure for work in progress in the accounts. The Tribunal found this action to be contrary to guidance in SSAP 9, FRS 5 and the infamous UITF 40.

However, the accounts for the year to 5 April 2000 did include work in progress of £60,000, which the Tribunal found to be 'inconsistent and incredible'. The stock valuations in each adjusted year of accounts were stated as round sum amounts of £2,000, £3,000 or £2,500.

The conclusion, after much discussion of which accounting practices applied in which periods, was that Mr Smith was assessed on additional profits of £233,920 over the years 1998 to 2002.

This case illustrates just how important it is to keep up with accounting practices and apply the accounting standards correctly.

From the practical tax newsletter of Mark Lee's Tax

Corporation Tax

Dawsongroup Plc v Revenue and Customs Comrs [2010] EWHC 1061 (Ch)

The taxpayer company (the company) was a holding company of a group of companies which carried on haulage and related activities. In 1988, it became a public company and 25 per cent of its shares were floated on the stock exchange. The remainder were owned by D and his family. In 2000, the decision was taken by those controlling and running the company that it would be best if the company were de-listed. Accordingly, D and his family bought out the external shareholders. The cost of the exercise was £433,000. The company then sought to deduct that sum when computing its profits for the purposes of corporation tax in relation to the relevant accounting year. The company claimed that it was entitled to make such a deduction because it was an "investment company" for the purposes of s 130 of the Income and Corporation Taxes Act 1988 (the Act), and that the sum in question was "disbursed as expenses of management" for the purposes of s 75(1) of the Act. The respondent, the Revenue and Customs Commissioners (the Revenue), disputed those claims and the matter eventually proceeded to an appeal before the first-tier tribunal. The judge found, inter alia, that the company was a trading company which carried out its business by means of subsidiaries which it controlled; that it held the shares in its subsidiaries as a necessary incidental to its chosen means of carrying on that activity; that the holding of the shares was not an end in itself, a business activity in its own right; and that it was in reality engaged in trade. He therefore concluded that it was not an investment company for the purposes of s 130 of the Act, and that, on that ground alone, the company's appeal had to fail (see [13] of the judgment). Notwithstanding that conclusion, the judge went on to consider the second question, namely, whether or not the sum in question was "disbursed as expenses of management" for the purposes of s 75(1) of the Act. Holding that, inter alia, there had to be a connection or identifiable relationship between the expenditure and the investment business of which it was said to be a part, he found that there was no such connection in the instant case and that, accordingly, the requirement of s 75 of the Act was not met. The company appealed.

The company submitted that the judge below had applied the wrong test or had reached a decision which no reasonable tribunal could have reached on the evidence before it in respect of both ss 130 and 75 of the Act.

(1) The Revenue's stance was that if the company had not carried on its admitted trading activities (the provision of services), its remaining activities would have amounted wholly or mainly to the making of investments for the purposes of the section. However, the company had trading activities, and those activities were the main activities of the company, or at least were significant enough to prevent the investment activities from being the sole or main activities. That was the correct contrast. It was not one which the judge below had drawn or relied on. He had therefore erred and his decision was flawed. However, in the circumstances of the case it was not necessary to remit the matter. There was, inter alia, an extensive statement of agreed facts, and the evidence could be read and a conclusion formed on the point. Performing that exercise, the overall picture was of a company whose main activity was being a holding company with a degree of real control over the rest of the group. The provision of services was very much ancillary to the holding activity and most of the controls exercised fell to be characterised, for the instant purposes, as holding investments. That being the case, the company was an investment company for the purposes of s 130 of the Act (see [27]-[28], [36]-[40] of the judgment).

Cook (Inspector of Taxes) v Medway Housing Society Ltd [1997] STC 90 considered.

(2) On the authorities, the following principles were relevant in considering what constituted "expenses of management": (i) the expression "expenses of management" was to be treated as an ordinary English expression, which was incapable of detailed definition; (ii) it was that expression, and that concept, which needed to be considered: the question was whether the expenditure fell within that category, and not whether it failed to fall within some other and thereby qualified by default (as it were); (iii) the expression was a wide or fairly wide one (the difference probably made no practical difference); and (iv) there was a distinction between the expenses of management and the general expenses of the business - an expense could fall within the latter category and not be within the former: the emphasis had to be on "management". In

addition, if one asked "management of what", it had to be management of the business of the company, which had to be investment business or mainly investment business (see [44]-[50] of the judgment).

In the instant case, the judge had correctly found that the expenditure had to be connected in some way with the investment business before any question could arise of its being an expense of management of that business. He had found that there had been no connection. On the facts, he had not made the error relied on. The relevant parts of para 31 of his judgment made it clear enough that he had apparently been applying the right test, and finding that the expenditure did not fall within it (see [53]-[54] of the judgment).

Sun Life Assurance Society v Davidson (Inspector of Taxes); Phoenix Assurance Co Ltd v Logan (Inspector of Taxes) considered; *Camas plc v Atkinson (Inspector of Taxes)* [2004] All ER (D) 51 (May) considered.

(3) The judge's reasons for arriving at his overall decision in the latter part of para 31 of his judgment were not readily ascertainable below the level of generalised findings, and some of the findings were ones that should not have been made. In those circumstances, the matter should be revisited; having considered the nature of the inquiry and the availability of the evidence, the right course was to consider the matter without further findings of fact from the judge below. That reconsideration having been conducted, it could be seen that the expenditure in question had been intended to improve the business in a broad sense. It had done so by making sure that there were more assets within the business, and by giving the directors more freedom in making business decisions. Those decisions had not related to the management of the investment business. They had related to the management of the investments. Accordingly, the point would be decided against the company, albeit for different reasons than those of the judge below (see [64]-[65], [71]-[72] of the judgment). The appeal would be dismissed.

Upper Tribunal (Tax and Chancery Chamber) Mann J, 11 May 2010

UK tax treatment of a US Limited Liability Company (LLC)

Background

On the basis of the principles set out in Memec plc v CIR (71 TC 77), it has been HM Revenue & Customs (HMRC) general practice to tax a UK resident member of an LLC on the profits of the LLC only if and when those profits are distributed by the LLC to its members.

A consequence of this treatment is that any tax paid in the US on the profits of the LLC is available for relief against UK tax only as underlying tax - and, as such, only to a UK company which controls, directly or indirectly, at least 10 per cent of the voting power in the LLC.

HMRC has not yet seen any examples of US LLCs for which it has considered this general practice to be inappropriate. But UK resident members have always been free to ask HMRC to review their particular circumstances if they believe that HMRC's general practice is inappropriate to them.

Decision by First Tier Tribunal (Tribunal) in Swift v HMRC

The Tribunal decided that the profits of a particular US LLC belonged to the individual members as they arose and that the UK member should be taxed accordingly. Since he was thereby taxed on the same income in both countries, he was entitled to double taxation relief for US tax paid on his share of the LLC's profits.

Implications for similar cases

HMRC has appealed the decision and intends, for the time being, to continue with its current general practices in relation to US LLCs. If, however, any member of a US LLC feels that the UK treatment of a particular LLC should be reviewed in the light of the decision of the Tribunal, they should write to Stan Surgin, Business International, Yorke House, Castle Meadow Road, Nottingham, NG2 1BG setting out fully why they believe that to be the case.

Ordinary Share Capital

It has been HMRC’s practice to accept that a Delaware LLC can in certain circumstances be regarded as having 'ordinary share capital' for the purposes of Section 832 ICTA 1988. See HMRC Business Brief 87/09.

The Tribunal found as fact that the members’ interests in the particular US LLC under consideration were 'not similar to share capital but something more similar to partnership capital of an English partnership'.

HMRC similarly intends to continue its general practice in this respect in relation to US LLC’s.

First Nationwide

In September 2003, the appellant, a UK resident private investment company and wholly-owned subsidiary of the Nationwide Building Society, entered into a stock loan agreement with AB, a bank in the Netherlands acting through a London branch.

Under the agreement, AB transferred shares in BC, a Cayman Islands resident company, to the appellant, who had to transfer them back after a period.

During its period of ownership of the shares, the appellant agreed to pay manufactured dividends to AB in respect of any dividend paid on the shares during the loan. The appellant also agreed to pay a fee of £325,000 to AB.

On the same date, the appellant and BC entered into a subscription agreement whereby the appellant would buy an identical amount of preference shares in BC.

In September 2004, the appellant sold the first batch of shares to AI for £50 million.

Before that, BC paid AB a total of £51 million in dividends in respect of the first batch of shares and the appellant paid manufactured dividend of £51 million to AB.

The appellant claimed the manufactured dividends as a management expenses in its tax return.

HMRC disallowed the claim, saying that the dividends were in fact a return of capital and therefore did not qualify as management expenses.

The First-tier Tribunal accepted the dividends were ‘dividends’ within the meaning of TA 1988, Sch 23A para 1(1). The dividends were paid out of a share premium account which was in law distributable profit.

They were not paid in the course of a winding-up nor were they reductions in capital. They were instead income in nature and thus overseas dividends within the meaning of Sch 23A.

The taxpayer’s appeal was allowed.

Greenbank Holiday Ltd

Greenbank Holidays Limited failed in its attempt to classify goodwill purchased from a related party as goodwill to which the intangible asset regime applied under the legislation permitting goodwill acquired from related parties to qualify in certain circumstances (old paras 118(1)(c) and 118(2), Sch 29, FA 2002, now in s 882, Corporation Tax Act 2009). (*Greenbank Holidays Ltd v HMRC*, TC00416).

The intangible asset regime commenced for goodwill created or acquired on or after 1 April 2002.

Goodwill is defined as having its meaning for accounting purposes, which (according to the old para 3(3), Sch 29, FA 2002) applied to intangible assets whether capitalised in company accounts or not.

The case considered the accounting standard FRS10 and noted that the standard refers to both purchased goodwill (which should be capitalised in appropriate circumstances) and internally-generated goodwill (which should not be capitalised).

Greenbank was at all material times a member of a UK corporate group whose parent company was Holidaybreak Plc, a UK listed company. The group was organised into three divisions, known as Camping, Hotel Breaks and Adventure.

Greenbank carried on the Camping division trade. The trade was that of a tour operator of camping holidays throughout Europe and involved the provision of self-catering holidays in mobile homes and tents pre-sited on a number of European campsites.

Some years ago (in or around 1998), in order to expand the business of the Camping division, Keyline Continental Limited, another tour operator, was acquired and became a member of the group.

Keyline as vendor and Greenbank as purchaser entered into an agreement dated 30 September 2003 for the sale and purchase of the camping and mobile home holiday business of Keyline (excluding certain specified assets) for a consideration of £46,632,000 and the assumption by Greenbank of various debts, liabilities and obligations of Keyline.

Following the acquisition of the Keyline business, Greenbank's accounts recognised an amount of £37,119,927 in respect of the goodwill relating to that acquisition. The accounts were prepared by Greenbank in accordance with UK GAAP.

The Tribunal concluded that Sch 29, FA 2002 was not confined to purchased goodwill (as contended by Greenbank), and that the goodwill acquired by Greenbank from Keyline existed at commencement and therefore could not come within the intangible asset regime.

Taxline, May 2010 Contribution by Chris Lallemand, Smith & Williamson

Interest was paid, but is this taxable?

A company received a sum described as compensation and/or restitution, following a successful claim against HMRC.

The claim was in respect of advance corporation tax (ACT) paid from 1993 to 1996 under a mistake of law and for interest thereupon until the date of settlement and the sum received precisely matched the claim to the principal and interest.

The return of the ACT represents the refund of taxes that, but for the mistake of law, would never have fallen due and is assumed to be non-taxable. The interest in question ran from the dates of payment of the ACT until settlement of the claim at the reference rate plus 1%.

This formula basis remained the same throughout the period, i.e. before and after the introduction of corporation tax self assessment.

Is this interest non-taxable due to the material date predating self-assessment or is it only taxable in respect of the amount accruing for accounting periods ending after 1 July 1999 (TA 1988, s 826(5) amended by FA 1998, s 34(3)) or, finally, is the entire amount taxable in that the interest was recognised in full in the 2009 accounting period (in accordance with UK GAAP).

Readers' advice would be very helpful.

Query 17,596 – Actor

Reply from Cello Boy

Actor raises the issue of whether interest on an advance corporation tax (ACT) refund received now, but running back to 1993, is partly non-taxable because of a rule change in the interim.

I assume that the ACT itself that was repaid was 'surplus' ACT that had been capped and could not be utilised, and therefore there was no question of the equivalent amount of mainstream corporation tax correspondingly becoming due.

Actor mentions corporation tax interest not being taxable prior to 1 July 1999 (that date being the advent of CT self-assessment). TA 1988, s 826 (interest on tax overpaid) applies to repayment interest after 30 September 1993 (the appointed day reference of s 826(1)(a) is given in SI 1992 No 3066).

Until 1 July 1999, within s 826 there were also subsections 826(5) to 826(5)(A). Section 826(5)(b) said that 'interest paid under this section… shall not be brought into account in computing any profits or income'.

But then s 826(5)(A) adds the proviso that s 826(5)(b) does not apply 'to a company within the charge to corporation tax'. Together they read to me that interest is taxable where the company is not dormant, etc.

But I must have missed a nuance elsewhere as despite my reading of these subsections as reproduced for posterity in the Butterworths notes, the tome goes on to clarify that there would be no charge to corporation tax on such interest received in periods ending before 1 July 1999.

The rewrite to CTA 2009, Sch 2 para 56 also states clearly that the interest would be non-taxable prior to this date.

In the 2007 *Fleming* VAT case ([2008] STC 324), recipients of credit interest on the repaid VAT running from the early 1990s were advised by HMRC that the interest was taxable (see point 29 of their *Fleming* guidance, and *Revenue & Customs Brief* 14/2009), and taxable under loan relationship rules per FA 1996, s 100 (what is now CTA 2009, s 479 to s 481).

> 'The period to which a payment relates is the period in which it would properly be recognised under generally accepted accountancy practice' (GAAP).

I am not aware of any dispute over these positions. It is not quite a direct parallel with the question because as far as I can see there was not over that period a point where VAT interest changed from being untaxed to taxed.

Returning to s 826, I can see nothing to disapply the application of GAAP. The default position of income under loan relationships is per GAAP according to CTA 2009, s 307(2).

Until the trigger point of the decision to repay the ACT with interest there could have been no accounting reason to bring those amounts into account in a prior period. So the interest should be reported as belonging to the one current period and fully taxable.

I do not believe that there are any grounds for the suggestion that the interest should be pro-rated between taxable and non-taxable just because the interest period over which it is calculated transcends a change in earlier rules.

In the same way that a capital gain may have accrued over changes in tax rules, it is taxed based on those in force when the gain is recognised. The 1999 year is becoming dim, but I do not recollect corporation tax repayments at the overlap then being apportioned between taxable and non-taxable.

I am not sure under which mechanism Actor and his client achieved the ACT repayment.

Sempra Metals was a 2007 case ([2007] STC 1559) regarding the question of interest restitution (following on from its earlier winning case regarding payment of ACT and under its previous incarnation as Metallgesellschaft Ltd), but there were many similar claims awaiting its result, and this could be related.

Although in Sempra itself compound interest was paid, the court said that aspect was discretionary based on the facts of that particular case, and not altering the general approach to statutory interest being 'simple'.

Actor has achieved an additional 1% interest (whether it is compound is irrelevant to the question), and I am assuming that the underlying reference rate is statutory interest under TA 1988, s 826.

I do not believe that – despite the description of Actor's settlement – the tax treatment could be considered as compensation giving rise to capital treatment, as the case summary of *Sempra* describes that payment as being the restitutionary right to payment of money or compensation by way of interest on advance corporation tax.

Taxation Forum, 19 May 2010

Reducing capital redemption reserve

I have a small private company client with an issued share capital of 25,000 £1 shares, and a capital redemption reserve (CRR) of £100,000 going back to a buy-back of shares some years ago.

The company also has negative distributable reserves at present which prevents it paying dividends.

The shareholders would like to significantly reduce their paid-up share capital to just 100 £1 shares using the Companies Act 2006 provisions involving a special resolution and a solvency statement.

They envisage creating distributable reserves from this process that would turn the existing negative reserves into a positive figure, which could then be used to pay out dividends over a period of time, as cashflow permits.

What they would really like to do, given the numbers involved, is to reduce the CRR to nil as part of the capital reduction process. This appears perfectly possible given the wording of CA 2006, s 733(6), which indicates that the CRR is to be regarded as part of the company's paid-up share capital.

The question is how can this be done? What are the mechanics for a reduction in share capital consisting partly of a CRR?

One possible way, it appears, would be to capitalise the CRR by issuing fully-paid bonus shares and then reducing them to nil.

However, the issue of these shares would be regarded as a distribution by virtue of the old TA 1988, s 210, as they follow a buy-back of shares.

This would not be of great concern provided that any actual repayment of the bonus shares did not give rise to any further taxation liability. Is this the case? Is there a more straightforward way of achieving the goal?

Suggestions from *Taxation* readers would be greatly appreciated.

Query 17,597 – Headscratcher

Reply from Thicket

The article Not all bad news! by David Jeffery gave a useful insight into the workings of the new provisions, comparing the new capital reduction rules with a company purchase of own shares. Coincidentally, I answered a readers' query (Can it be right?) on the same subject in the same issue.

In this question, Headscratcher has hit upon the key provision in Companies Act 2006, s 733(6) which states that subject to using the capital redemption reserve (CRR) to issue new shares to members as bonus shares:

> 'The provisions of the Companies Acts relating to the reduction of a company's share capital apply as if the capital redemption reserve were part of its paid-up share capital.'

This can be taken at face value. There is no requirement to use the CRR to issue bonus shares first. Rather, the capital reduction procedures in CA 2006, Ch 10 can be applied to the CRR as if it were share capital.

The effect is to reduce the capital (i.e. the shares, or CRR which is treated as share capital for this purpose) and to create a 'reserve' of a similar amount.

While CA 2006, s 654 states that this new reserve is not distributable, it is trumped by the Companies (Reduction of Share Capital) Order SI 2008 No 1915 which has effect to make the reserve distributable. It can be returned to members to the extent that overall distributable reserves are in credit and cash is available (or other assets may be distributed 'in kind').

The capital reductions that I have experienced involved reducing the number of issued shares. The resolution stated that the reduction was pro-rata across all the shareholders.

But I understand that it could equally specify that the reduction applied solely to a particular shareholder, or any combination of shareholders, so that only his or their shares were reduced.

When dealing with a reduction in the CRR, there is no immediate question of having to identify any particular shareholder because the CRR belongs to the company as a whole.

Having transformed the CRR into a distributable reserve, how this is to be distributed will need to be addressed in the same way as any other dividend.

Tax law on the receipt of dividends seems to be in a bit of a mess at the moment (see the Feedback item Different words by Pete Miller).

My own view of the general position is that a distribution from a company will be subject to income tax in the hands of individual shareholders (ITTOIA 2005, s 383) unless it can be demonstrated to be 'capital' (most commonly a return of the capital originally subscribed for, or a distribution in the course of winding up) in which case TCGA 1992, s 122 applies. This may not be what the legislation says, but that is how I always understood it and I hope that is where we end up.

Headscratcher mentions TA 1988, s 210. In general, bonus shares fall within the reorganisation rules and are tax neutral for shareholders.

However, a bonus issue will be treated as an income distribution if it is a bonus issue of securities or redeemable shares or if it is preceded by or follows a repayment of capital.

For example, it is not possible to issue bonus shares and then get capital treatment if they are subsequently repaid. In effect, this would be returning distributable reserves to shareholders as capital gain rather than as income. This anti-avoidance rule should not apply here because: (a) there is no bonus issue – the CRR becomes a distributable reserve; and (b), as set out above, any distribution in respect of the CRR will be an income distribution in any event.

As a transaction in securities, HMRC clearance under ITA 2007, s 701 is available and should be sought where the scheme involves a return of capital and capital gains tax treatment is anticipated.

Detailed knowledge of company law and company secretarial procedures will be required and I certainly recommend that a competent commercial lawyer is brought on board the advisory team at an early stage. Experience suggests that lawyers are keen to cut their teeth on this new area.

Taxation Forum, 19 May 2010

Value Added Tax

VAT corrections

Following a pair of recent Tribunal cases which turned on the rules involved in correcting mistakes in the VAT account, this article examines those rules and reviews the problems that the traders created for themselves which resulted in a Tribunal hearing – one successful, one unsuccessful.

The law on corrections is found in the General VAT Regulations, SI 1995/2518, regs.34, 35 and 38.

34 Correction of errors

(1) Subject to paragraph (1A) below this regulation applies where a taxable person has made a return, or returns, to the Controller which overstated or understated his liability to VAT or his entitlement to a payment under section 25(3) of the Act.

(1A) Subject to paragraph (1B) and (1C) below, any overstatement or understatement in a return where—

(a) a period of 4 years has elapsed since the end of the prescribed accounting period for which the return was made; and

(b) the taxable person has not (in relation to that overstatement or understatement) corrected his VAT account in accordance with this regulation before the end of the prescribed accounting period during which that period of 4 years has elapsed,

shall be disregarded for the purposes of this regulation; and in paragraphs (2) to (6) of this regulation "overstatement", "understatement" and related expressions shall be construed accordingly.

(1B) Paragraph (1A) above does not apply where—

(a) the overstatement or understatement is discovered in a prescribed accounting period which begins before 1st May 1997; and

(b) the return for that prescribed accounting period has not been made, and was not required to have been made, before that date.

(1C) Where paragraph (1B) above does not apply, any overstatement or understatement in a return shall be disregarded for the purposes of this regulation where the prescribed accounting period for which the return was made or required to be made ended on or before 31st March 2006.

(2) In this regulation—

(a) "under-declarations of liability" means the aggregate of—

(i) the amount (if any) by which credit for input tax was overstated in any return, and

(ii) the amount (if any) by which output tax was understated in any return;

(b) "over-declarations of liability" means the aggregate of—

(i) the amount (if any) by which credit for input tax was understated in any return, and

(ii) the amount (if any) by which output tax was overstated in any return.

(3) Where, in relation to all such overstatements or understatements discovered by the taxable person during a prescribed accounting period, the difference between—

(a) under-declarations of liability, and

(b) over-declarations of liability,

does not exceed £50,000, the taxable person may correct his VAT account in accordance with this regulation.

But if Box 6 of the taxable person's return for the prescribed accounting period must contain a total less than £5,000,000, the difference must not for these purposes exceed 1% of that total unless the difference is £10,000 or less.

(Box 6 must contain the total value of sales and all other outputs excluding any VAT – see regulation 25 and Schedule 1 Forms 4 and 5.)

(4) In the VAT payable portion—

(a) where the amount of any overstatements of output tax is greater than the amount of any understatements of output tax a negative entry shall be made for the amount of the excess; or

(b) where the amount of any understatements of output tax is greater than the amount of any overstatements of output tax a positive entry shall be made for the amount of the excess.

(5) In the VAT allowable portion—

(a) where the amount of any overstatements of credit for input tax is greater than the amount of any understatements of credit for input tax a negative entry shall be made for the amount of the excess; or

(b) where the amount of any understatements of credit for input tax is greater than the amount of any overstatements of credit for input tax a positive entry shall be made for the amount of the excess.

(6) Every entry required by this regulation shall—

(a) be made in that part of the VAT account which relates to the prescribed accounting period in which the overstatements or understatements in any earlier returns were discovered,

(b) make reference to the returns to which it applies, and

(c) make reference to any documentation relating to the overstatements or understatements.

(7) Where the conditions referred to in paragraph (3) above do not apply, the VAT account may not be corrected by virtue of this regulation.

35

Where a taxable person has made an error—

(a) in accounting for VAT, or

(b) in any return made by him,

then, unless he corrects that error in accordance with regulation 34, he shall correct it in such manner and within such time as the Commissioners may require.

38 Adjustments in the course of business

(1) This regulation applies where—

(a) there is an increase in consideration for a supply, or

(b) there is a decrease in consideration for a supply,

which includes an amount of VAT and the increase or decrease occurs after the end of the prescribed accounting period in which the original supply took place.

(1C) Where an increase or decrease in consideration relates to a supply in respect of which it is for the recipient, on the supplier's behalf, to account for and pay the tax, the prescribed accounting period referred to in paragraph (1) is that of the recipient, and not the maker, of the supply.

But this paragraph does not apply to the circumstances referred to in regulation 38A.

Where this regulation applies, both the taxable person who makes the supply and a taxable person who receives the supply shall adjust their respective VAT accounts in accordance with the provisions of this regulation.

(3) Subject to paragraph (3A) below, the maker of the supply shall—

(a) in the case of an increase in consideration, make a positive entry; or

(b) in the case of a decrease in consideration, make a negative entry,

for the relevant amount of VAT in the VAT payable portion of his VAT account.

(3A) Where an increase or decrease in consideration relates to a supply on which the VAT has been accounted for and paid by the recipient of the supply, any entry required to be made under paragraph (3) shall be made in the recipient's VAT account and not that of the supplier.

(4) The recipient of the supply, if he is a taxable person, shall—

(a) in the case of an increase in consideration, make a positive entry; or

(b) in the case of a decrease in consideration, make a negative entry,

for the relevant amount of VAT in the VAT allowable portion of his VAT account.

(5) Every entry required by this regulation shall, except where paragraph (6) below applies, be made in that part of the VAT account which relates to the prescribed accounting period in which the increase or decrease is given effect in the business accounts of the relevant taxable person.

(6) Any entry required by this regulation to be made in the VAT account of an insolvent person shall be made in that part of the VAT account which relates to the prescribed accounting period in which the supply was made or received.

(7) None of the circumstances to which this regulation applies is to be regarded as giving rise to any application of regulations 34 and 35.

Notice

HMRC's policy and practice on the matter is set out in Notice 700/45/09. The main section that is relevant to this article is section 4, correcting errors on returns already submitted.

4.1 Errors discovered for return periods beginning on or after 1 April 2008 with a due date on or after 1 April 2009 – The Penalties for Errors regime

— Errors or inaccuracies relating to return periods beginning on or after 1 April 2008 where the due date for the return is on or after 1 April 2009 will be liable to a penalty if they are careless or deliberate.

— If a person discovers a non-careless error, HMRC expects that they will take steps to correct it. If the person does not take steps to correct it, the inaccuracy will be treated as careless and a penalty will be due.

— Careless or deliberate inaccuracies relating to returns commencing on or after 1 April 2008 with a due date on or after 1 April 2009, that are being corrected using Method 1 or 2, will be subject to the new penalty regime.

— Where careless or deliberate behaviour results in an incorrect error correction notification being made under Method 2 you will be subject to a penalty if it is correcting errors made on returns commencing on or after 1 April 2008 with a due date on or after 1 April 2009. This applies regardless of whether the original errors were made despite taking reasonable care or not.

— In order for HMRC to consider any reduction to a penalty, you should tell us if you have made a careless error or deliberate inaccuracy regardless of its size or value. Although we also require separate disclosure for the purpose of reducing any penalty, careless errors may be adjusted on your next VAT return subject to the limits described in this section.

— Correction of deliberate inaccuracies must, however, always be notified to HMRC using form VAT 652; please see below for more information. In such circumstances you should complete the VAT652 and provide a description of the inaccuracy. Tell us the full amount of the inaccuracy and explain how and why the inaccuracy arose (continue on a separate sheet if necessary.)

— If you have adjusted a careless error/inaccuracy on your return that is within the limits described below you may still write to HMRC asking us to consider any reduction to a penalty. Your letter should contain the same information that is required on form VAT 652, but it is important that you also tell us that you have made the adjustment on your return. The majority of such errors will not be careless or deliberate, so no penalty will be due. People make mistakes and we do not expect perfection. When considering whether an error was careless, we are simply seeking to establish whether the person has taken the care and attention that could be expected from a reasonable person taking reasonable care in similar circumstances.

4.2 Methods for correcting errors

There are two methods for correcting errors—

— Method 1: for errors of a net value that do not exceed £10,000, or errors of a net value between £10,000 and £50,000 that do not exceed the limit described in paragraph 4.3

— Method 2: for errors of a net value between £10,000 and £50,000 that exceed the limit in paragraph 4.3, or for net errors greater than £50,000, or if you so choose, for errors of any size.

See paragraph 4.6 and 4.7 for further details on time limits and the transitional period extending the time limits from three to four years.

4.3 Method 1—for errors of a net value that do not exceed £10,000 or errors of a net value between £10,000 and £50,000 that are within the limits described below:

You can use this method to adjust your VAT account and include the value of that adjustment on your current VAT return providing:

— the net value of errors found on previous returns does not exceed £10,000, or

— the net value of errors found on previous returns is between £10,000 and £50,000 but does not exceed 1 per cent of the box 6 (net outputs) VAT return declaration due for the return period in which the errors are discovered

To work out the net value of VAT errors on previous returns, you should work out:

— the total amount due to us, if any, and

— the total amount due to you, if any.

If the difference between the two figures is greater than £10,000 and exceeds 1 per cent of the box 6 (net outputs) VAT return declaration due for the current return period during which the error is discovered, you must use Method 2. You must always use Method 2 if the net errors exceed £50,000 or if the errors made on previous returns were made deliberately.

4.4 Method 2: for errors of a net value between £10,000 and £50,000 which exceed the limits described below, or errors which exceed £50,000 or for errors of any size

You must use this method if:

— the net value of errors found on previous returns is between £10,000 and £50,000 and exceeds 1 per cent of the box 6 (net outputs) VAT return declaration due for the current return period during which the error was discovered, or

— the net value of errors found on previous returns is greater than £50,000, or

— the errors on previous returns were made deliberately.

You may, if you wish, use this method for errors of any size which are below the limits at paragraph 4.3 above instead of a method 1 error correction. If you use this method you must not make adjustment for the same errors on a later VAT return.

When notifying HMRC of an error correction you should use form VAT 652. This can be printed from our website at www.hmrc.gov.uk or your can request a form by contacting our Helpline on 0845 010 9000.

If you are unable to obtain a form you should, by reference to business records in your possession, write to the appropriate office at paragraph 4.11 and provide full details of the errors including:

— how each error arose

— the VAT accounting period in which it occurred

— if it was an input tax or output error

— the VAT underdeclared or overdeclared in each VAT period

— how you calculated the VAT underdeclared or overdeclared

— whether any of the errors resulted in you paying us an amount that wasn't due, and

— the total amount to be adjusted.

If the error was an amount underdeclared please include sufficient detail about the error on a separate sheet if necessary, to enable us to decide whether we should charge interest. You can find further information about interest in Notice 700/43 "Default interest" (Part V8).

4.5 Which method should I use?

If the net value of errors…

do not exceed £10,000 or are between £10,000 and £50,000 but do not exceed 1 per cent of the box 6 (net outputs) VAT return declaration due for the current return period during which the errors are discovered, you can use Method 1 or 2.

If they are between £10,000 and £50,000 and exceed 1 per cent of the box 6 (net outputs) VAT return declaration due for the current period during which the errors are discovered, or are greater than £50,000 you must use Method 2.

If the errors on previous returns were made deliberately you must use Method 2.

4.6 What's the time limit for correcting errors?

You cannot adjust your VAT return, or make an error correction notification, for any errors that arose in accounting periods that are outside the time limits at paragraphs 4.6.1 and 4.7, unless the errors are tax points errors, that is, where you've declared an amount of VAT on the return that immediately precedes or follows the return for which the amount was due.

4.6.1 Transitional arrangements for the increase in time limits from three years to four years

The time limit for adjusting returns and correcting errors, including making claims, was increased with effect from 1 April 2009 from three years to four. However, in order to ensure that accounting periods that were out-of-time on 31 March 2009 are not brought back in-time by the change, transitional arrangements have been put in place.

The transitional arrangements provide that no adjustment or error correction notification made between 1 April 2009 and 31 March 2010 can be made for any accounting period ending before 1 April 2006.

For instance, on 31 March 2009 the earliest accounting period for which a claim may be made for a refund of overdeclared output tax under s 80(1) of VATA 1994 is the accounting period ending on 31 March 2006 (the old three year rule).

On 30 April 2009, the earliest accounting period for which a claim may be made under section 80(1) would be that ending on 30 April 2006.

Similarly, on 31 October 2009 the earliest accounting period that can be claimed for will also be that ending on 30 April 2006.

However, by 30 April 2010, the four-year time limit will have come fully into effect so that a claim made on that date can still go back to a quarter ending on 30 April 2006.

For non-standard tax periods, return adjustments and error correction notifications made between 1 April 2009 and 1 April 2010 can be made for any accounting period ending on or after 1 April 2006. Adjustment thereafter will be subject to a four-year limit.

4.7 What's the time limit for claiming input tax?

The time limit for making claims was increased with effect from 1 April 2009 from three years to four. However, in order to ensure that the accounting periods that were out-of-time on 31 March 2009 are not brought back in-time by the change, the following transitional arrangements apply.

The transitional arrangements provide that no claim made between 1 April 2009 and 31 March 2010 can be made for any accounting period for which the VAT return was due before 1 April 2006.

Thus, on 31 March 2009, the earliest accounting period for which a claim may be made is that ending on 28 February 2006 (for which the due date of the return was 31 March 2006).

On 30 April 2009, the earliest accounting period for which a claim may be made under regulation 29 would be that ending on 31 March 2006 (the due date of the return for the period being 30 April 2006).

Similarly, on 31 October 2009, the earliest accounting period that can be claimed for will also be that ending on 31 March 2006. However, by 30 April 2010, the four-year time limit will have come fully into effect so that a claim made on that date can go back to the quarter ending 31 March 2006.

4.8 What if I don't correct VAT errors and you find them?

4.8.1 For accounting periods prior to the introduction of the Penalties for Errors regime (see paragraph 4.1) the following procedures apply

If we find underdeclarations of VAT on your returns, we will assess for the tax due and may charge interest. You may also face a misdeclaration penalty.

To avoid a penalty, you must disclose full details of the mistakes before we begin to make enquiries into your VAT affairs.

Enquiries normally begin when we make an appointment to inspect your records. But we will accept disclosures for penalty purposes after this point, unless we have reason to believe that:

— you discovered the errors earlier and disclosed them only because you had been told that a visit was to be made, or

— your disclosure during or after a visit was prompted by our enquiries into your affairs.

You should make an error correction by following the procedures at paragraph 4.3 to 4.5. If, however, you deliberately fail to correct an underdeclaration of VAT, you may be liable to a civil penalty for dishonest evasion or even criminal prosecution.

You can find further information in:

— Notice 700 "The VAT Guide" (Part V8)

— Notice 700/42 (Part V8), and

— Notice 730 (Part V8).

4.8.2 For accounting periods after the introduction of the Penalties for Errors regime (see paragraph 4.1) the following procedures apply

If we find underdeclarations of VAT on your VAT returns, we will assess for the tax due and may charge interest. You may also be liable to a penalty.

You should make an error correction by following the procedures at paragraphs 4.3 to 4.6.

Please see paragraph 4.1 for more information in relation to error correction and the Penalties for Errors regime.

4.9 Should I correct errors that have little effect on the net VAT that I declared?

There may be ocassions when large output and input tax errors have a nil or minimal effect on the net VAT due on returns. If the net value of errors you've found on previous VAT returns is within the limit described in paragraph 4.2, you can choose either Method 1 or 2 (described in paragraphs 4.3 and 4.4) to correct the errors.

In order for us to consider any reduction to a penalty, you should tell us if you have made a careless error or deliberate inaccuracy in individual VAT return declarations understating liability to pay VAT, or overstating entitlement to a VAT credit, regardless of its size or value.

4.10 What about adjustments that aren't errors?

Provided they are accurate and made at the right time, adjustments that you are required to make as part of the normal operation of VAT accounting are not errors.

These accounting adjustments include:

- retail scheme annual adjustments, or other adjustments required when a person stops using a particular retail scheme
- adjustments under the Capital Goods Scheme
- an approved estimation procedure
- partial exemption adjustments
- partial exemption clawback and payback adjustments
- exports and intra-European Community supplies of goods
- issuing or receiving credit and debit notes
- claims for bad debt relief, and
- pre-registration and post deregistration expenses.

If the original accounting adjustment was incorrect, or made at the wrong time, error corrections should be made in the normal way.

4.11 Where do I send error correction notifications?

Separate notification of error corrections should include the person's VAT registration number and be sent to the relevant VAT Error Correction Team (VATECT) office from the list below. [list omitted].

4.12 When should I correct errors?

As soon as you find an error, you should record it in your VAT records for correction or you could become liable to a penalty.

You may find it useful to keep a separate record in your current VAT account that you can update as errors are discovered. You should:

- show the date the error was discovered
- show the period in which the error occurred
- identify any related documentation, and
- identify whether the error was output or input tax related.

At the end of your current VAT period, the record will help you decide whether Method 1 or Method 2 is the appropriate method to use when correcting errors.

You should normally wait until the end of the current accounting period before deciding whether Method 1 or Method 2 applies.

However, if an individual error is so large that the 1 per cent box 6 test, or £50,000 limit, referred to in paragraph 4.4 will inevitably be breached, you should make an error correction report to HMRC using Method 2 immediately.

Credit notes

Reg.38 allows for a specific type of correction. Where a VATable supply has been made and an invoice issued showing the VATable consideration, and there is then either a change in the agreed consideration or a cancellation of the supply, then reg.38 can be used to alter the VAT payable. This lecture is concerned with reductions in VAT, so it will deal only with an agreed reduction in the consideration (e.g. on allowing for some defect in the product) or an agreed cancellation of the supply (e.g. on return after the product proved wholly unsatisfactory).

The law provides for the issue of a credit note to the customer to reflect a decrease in the consideration (reg.24 SI 1995/2518); although the issue of a credit note is not explicitly referred to in reg.38, that regulation requires that the VAT adjustments made by both the supplier and the customer must be symmetrical, and HMRC will expect to see a credit note being issued to ensure that this is the case. This is set out in para.19.10 in Notice 700.

Reg.38 can only be used to adjust the VAT on a supply where there was consideration and the consideration changes. It cannot be used to correct a mere arithmetical error where the total price remains the same.

Recent cases

A real credit note?

A married couple carried on a number of similar property investment businesses. Two of these were a partnership and a company, both registered for VAT under separate numbers.

In January 2006 the company sold two properties which it had bought in October 2004, realising a profit of £550,000. The couple wanted to transfer funds from the company to the partnership, so they raised an invoice for £525,000 of "professional fees in connection with the management and disposal of [the properties]". VAT was added to the invoice, paid by the company and reclaimed as input tax.

HMRC visited the company in October 2006 and noted that the company had notified an option to tax in December 2005 stating that no exempt rents had been received before that date. However, this was not true: there had been exempt income, and HMRC ruled that the option was invalid. The input tax was therefore disallowed.

The company then suggested that the payment had been treated erroneously as a management charge when it was in reality a dividend. It was treated as such for accounting and tax purposes by the company and the recipients. The partnership issued a credit note to the company (only for the VAT element) and adjusted its output tax in its December 2006 return. A new management charge for only £40,000 plus VAT was raised. HMRC assessed the partnership in September 2007 to recover the output tax on £525,000 again, arguing that the credit note was invalid.

In the early stages of the dispute there was some confusion about whether the company would appeal against the disallowance of the input tax (arguing among other things that HMRC could have given retrospective approval for the option) or the partnership would appeal against the output tax, but it was the output tax issue that went before the Tribunal. The partnership argued that the payment did not represent consideration for any taxable supply, and the credit note was therefore effective for VAT purposes to cancel any VAT liability.

HMRC's main contention was that the invoice reflected the reality of the transaction, and the credit note was an attempt to change the situation afterwards when it was discovered that the first version did not have a favourable result.

The Tribunal accepted the appellant's counter-argument that the original invoice was not a proper reflection of the facts, even though it was not intended to deceive and was not a sham. There were genuine and understandable reasons for the partners wishing to route the distribution of profits through the partnership, rather than receiving them directly in their personal capacity as shareholders, and that did not change the nature of the payments. A management charge of £525,000 would be out of all proportion with fees charged for other work. The appeal was allowed.

First Tier Tribunal (TC00374): Stirling Investments

No supply

A company manufactured UPVC window units. It provided authorised dealers with promotional examples of the product to display in their showrooms. These items were not for sale, and the dealers would only have to pay for them if they breached conditions attaching to the dealership agreement (e.g. ceasing to sell exclusively this manufacturer's products). To record the delivery of the items to the dealers, the company raised an invoice, but it was understood that the invoice would not be payable unless the conditions were breached.

A director of the company realised in December 2003 that the invoices had been processed in the ordinary way and output tax had been accounted for on them. He obtained a schedule of the items concerned and adjusted the VAT account for the December 2003 return, reducing output tax in Box 1 on the basis that no supplies had been made. No credit notes were sent to the customers.

HMRC enquired into the return and ruled that the adjustment was not correct. After lengthy argument, the trader appealed an assessment reversing the adjustment.

The Tribunal examined the history of the dispute and concluded that the assessment was correct. The company had two arguments to support its case:

the adjustment was a valid use of reg.38 SI 1995/2518 on the correction of errors;

the company had made a valid voluntary disclosure.

On the use of reg.38, the Tribunal concluded that it was not possible to use that regulation where an invoice had been incorrectly issued for something that was not a supply at all. It referred to the cancellation of a supply or a change in the consideration for a supply, but that presupposed that there had been a supply. Further, the company had not issued credit notes to the customers, so even if there had been a supply, the conditions of reg.38 were not met.

It appears that the only way to cancel a wholly invalid invoice is to make a voluntary disclosure to HMRC (it is presumably also necessary to inform the customer that the invoice should not be used to support input tax deduction). In this case, the full details of the make-up of the adjustment had never been given to HMRC. A voluntary disclosure requires the company to provide the information: it should not be necessary for HMRC to piece it together over a period of time from partial answers and further enquiries.

First Tier Tribunal (TC00430): Starglaze Windows & Conservatories Ltd

Note that the company could not have claimed bad debt relief for invoices unpaid after 6 months. The conditions of s.36 VATA 1994 also require that there has been a supply in the first place, and it is also necessary for the due date for payment to have passed.

Contributed by Mike Thexton

Lecture B600 (17.23 Minutes)