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Emergency Budget

Summary of Budget held on 22 June 2010

Note: *It must be remembered that these proposals are subject to amendment.*

ADMINISTRATION OF TAX

HMRC Powers: Penalties for Late Filing of Returns and Payment of Tax

New penalties are to be introduced for late filing of returns and late payment of taxes, extending the penalty regime set out in FA 2009, Schs 55 and 56 to various indirect taxes. The taxes covered include VAT, insurance premium tax, aggregates levy, climate change levy, landfill tax and excise duties. The implementation of the penalties will be staged over a number of years and brought into effect by Treasury order.

Under the new rules, there will be an escalating series of penalties depending on the number of failures within a set penalty period. Further penalties will arise if there is a prolonged delay in filing returns or paying the tax due.

Failure to file a quarterly return by the filing date will trigger a penalty period of 1 year and an immediate £100 penalty. The fixed penalty will then escalate by £100 for each subsequent failure within the period, up to a maximum of £400, and the period itself will be extended to the first anniversary of the latest failure. Additional penalties of 5% of the tax on the return will be charged for continuing failure 6 and 12 months after the filing date. Penalties of up to 100% of the tax will be charged where the failure is intended deliberately to withhold information to prevent HMRC correctly assessing the tax.

Failure to pay tax due quarterly will also trigger a 1-year penalty period although no immediate penalty will apply. A second failure in the period will attract a penalty of 2%, a third failure a 3% penalty and further failures a 4% penalty. Again, the penalty period is extended with each failure. Additional penalties of 5% of the tax will be charged for continuing failure 6 and 12 months after the due date.

Similar penalties will apply in relation to monthly returns and payments.

The taxpayer may appeal against a penalty decision if he has a reasonable excuse for the lateness. Late payment penalties may also be avoided where the taxpayer has agreed a ‘time to pay’ arrangement with HMRC.

HMRC Powers: Excise Modernisation and Compliance Checks

The Government is to introduce legislation which will bring the compliance checking framework for excise duties into line with other duties and taxes. In particular:

- the high-level rules for record-keeping will be aligned, detailed record-keeping rules will not be affected;
- information and inspection powers will be updated;
- the standard time limit for making claims will be increased from 3 years to 4 years;
- the extended 20-year time limit for deliberate underpayment of excise duty will be retained, but the terminology used to describe the behaviours subject to it will be aligned with recent penalties legislation.

The record-keeping proposal and amendments to information and inspection powers are expected to have effect from 1 April 2011. The changes to time limits require a transitional period and will not become fully effective until 1 April 2012.

Tax Law Making

The Government has issued a 24-page discussion document entitled ‘Tax Policy Making: A New Approach’. This is intended ‘to improve the way tax policy is made’, and to support the objectives of predictability, stability and simplicity. The Government has also confirmed its intention to create an

independent Office of Tax Simplification, and will announce further details shortly. It has also announced that it intends to impose 'sunset clauses' on regulations, under which they will cease to be law after 7 years unless Parliament has confirmed that they are still necessary and proportionate, or they were explicitly set to have a longer timeframe.

PERSONAL TAXATION

Personal Allowance, Basic Rate Limit and NICs Thresholds for 2011/12

From 6 April 2011 the personal allowance for those aged under 65 will be increased by £1,000 to £7,475. In order that higher rate taxpayers do not benefit from this increase the basic rate limit will be reduced by a figure to be confirmed when September's Retail Prices Index is known.

The upper earnings limit and upper profits limit for National Insurance contributions will be reduced accordingly.

The secondary threshold, the starting point for payment of employers Class 1 National Insurance contributions will be increased by £21 per week above indexation. This is in addition to the planned increase in the primary threshold and the 1% increase in rates already planned for 2011/12.

Changes to the Rules on Deduction of Income Tax at Source

HMRC will have the power to amend the rules relating to how and when individuals and non-corporates need to report and remit income tax that they are required to deduct from certain payments, e.g. interest, patent royalties and other annual payments. This measure will not apply to companies making such payments.

The current regime is set out in primary legislation (ITA 2007, s 963), but with effect from the date of Royal Assent to the autumn Finance Bill, HMRC will be able to make regulations to change these rules.

Special Guardianship Orders and Residence Orders

A new income tax exemption for qualifying guardians is to be introduced with backdated effect from 6 April 2010 for payments received on or after that date. The legislation will be included in a Finance Bill to be introduced as soon as possible after the summer recess.

The exemption will apply to 'qualifying payments' made to 'qualifying guardians'. 'Qualifying guardians' are individuals who care for one or more children placed with them under a special guardianship order or under a residence order (where the individual is not the child's parent or step-parent). 'Qualifying payments' are payments made to the carer by the child's parents or by (or on behalf of) a local authority, in relation to a special guardianship order or a residence order.

Kinship carers who are providing care to a child who has not been placed with them under a residence order will not be qualifying guardians for the purposes of the above exemption. However, they will be entitled to claim the new income tax relief for Shared Lives carers. Broadly they can choose to pay tax only on the excess of their care income above a certain limit or on their actual profits computed under the normal income tax rules for businesses.

Income Tax Relief for Shared Lives Carers

Existing non-statutory guidance is to be superseded by new legislation with backdated effect from 6 April 2010. The legislation will be included in a Finance Bill to be introduced as soon as possible after the summer recess. There will be a single relief (to be known as 'qualifying care relief') for qualifying Shared Lives carers, and this will be based on a tax-free allowance. Carers whose Shared Lives earnings do not exceed the tax-free allowance will not be taxed on their income from providing Shared Lives care. Carers whose Shared Lives earnings are more than the tax-free allowance have the option to choose to be taxed on:

- their total receipts from providing care less the tax-free allowance; or
- their actual profits computed using the normal tax rules for businesses.

This will operate in a similar way to existing relief for foster care. The tax-free allowance will be available per household and consist of:

- a £10,000 fixed amount per tax year;

- £200 per week (or part week) per placement aged under 11; and
- £250 per week (or part week) per placement aged 11 or over.

Where there is more than 1 carer in the household, the household may provide care to a maximum of 3 Shared Lives placements, and the allowance will be shared equally between the carers. If the carer is entitled to both foster care relief and the relief for Shared Lives carers, the household will only be entitled to claim 1 £10,000 fixed amount per tax year.

For the tax year 2010/11 only, Shared Lives carers can choose between the pre-existing non-statutory arrangements for adult placement carers and the new tax-free allowance. The non-statutory arrangements will then be withdrawn from 2011/12.

EMPLOYMENT TAXATION

Expenses Paid to MPs

Amendments are to be made to the income tax and NIC provisions dealing with MPs' expenses. The amendments are required following the introduction of a new scheme for expenses developed by the Independent Parliamentary Standards Authority and take effect retrospectively from 7 May 2010. The amendments deal with additional accommodation expenditure, the costs of visits to EU institutions and other parliaments, travel expenses and costs of evening meals when the House of Commons is sitting late.

Seafarers' Earnings Deduction: EU and EEA Residents

The seafarers' earnings deduction will be extended to EU and EEA-resident seafarers with effect from 6 April 2011. Seafarers' earnings deduction (SED) can provide 100% UK tax relief for the earnings from carrying out duties as a seafarer wholly or partly outside the UK, during an eligible period. The condition that the claimant must be ordinarily resident in the UK to qualify for SED will be extended so that seafarers who are EU or EEA residents can claim the deduction on their earnings as a seafarer which are liable to UK income tax.

Regional Employer NICs Holiday for New Businesses

The Government will introduce a scheme to help new businesses in targeted areas of the UK. During a 3-year qualifying period new businesses starting up in these areas will not have to pay the first £5,000 of employers Class 1 NICs due in the first 12 months of employment in respect of each of the first 10 employees hired in the first year of business, giving a potential saving of £50,000.

The areas are: Scotland; Wales; Northern Ireland; the North East; Yorkshire and the Humber; the North West; the East Midlands; the West Midlands; and the South West.

Subject to meeting the necessary legal requirements the scheme is intended to start no later than 6 September 2010. Any new businesses set up from 22 June 2010 may benefit from the scheme. They will be liable to pay employers NICs in the period before the start of the scheme but will receive an NIC holiday of equal duration once the scheme starts. Only businesses which undertake a sufficient degree of new economic activity will benefit. Full details of the scheme and who is eligible to participate will be made available shortly. Some employees such as those operating under companies caught by the IR35 rules or those engaged through managed service companies will not be eligible. Some business sectors will be excluded, including the coal sector, and restrictions will be applied to the agriculture and fisheries sectors. Individuals employing staff, for example for personal services, will also be excluded.

BUSINESS TAX

Capital Allowances: Rate and Annual Investment Allowance Changes

For chargeable periods ending on or after 1 April 2012 for corporation tax and 6 April 2012 for income tax, the rate of writing-down allowances for new and unrelieved expenditure on plant and machinery will be reduced to 18% in the main rate pool and 8% in the special rate pool. In addition, the maximum amount of annual investment allowance will be reduced to £25,000 from April 2012.

Hybrid rates will apply to businesses whose chargeable period spans the change date for the writing-down allowance. These will be calculated based on the proportion of the chargeable period falling before and after the change date.

Oil and gas ring-fence activities will retain their existing capital allowances treatment.

Capital Allowances Rules for Qualifying Carers

If a foster carer's income is over a certain limit, the foster carer may choose to pay tax on:

- care income above that limit; or
- actual profits computed using the normal tax rules for businesses (including capital allowances).

Similar rules are being introduced for Shared Lives carers. The choice between the 2 alternatives above is made on an annual basis, so carers may be entitled to capital allowances for 1 year but not for the next and vice versa. There are already special rules in place to facilitate the switch into and out of a capital allowances regime.

Legislation is to be included in a Finance Bill introduced as soon as possible after the summer recess to correct technical anomalies in these special rules to ensure that they operate as intended. For example, when a carer re-enters the capital allowances regime, the carer will be treated as having acquired assets he already owns for the smaller of:

- the market value of the asset; or
- the unrelieved expenditure that was in the capital allowances pool at the end of the last chargeable period for which the carer was entitled to claim capital allowances.

The changes will apply to chargeable periods ending on or after the date that the legislation receives Royal Assent.

Zero-Emission Goods Vehicles: 100% First-Year Allowances

Expenditure incurred on new and unused zero-emission goods vehicles on or after 1 April 2010 and before 1 April 2015 for corporation tax and on or after 6 April 2010 and before 6 April 2015 for income tax will qualify for 100% first-year allowances (FYA). A zero-emission goods vehicle is one that cannot under any circumstances produce CO_2 emissions when driven.

The general exclusions for FYAs under CAA 2001, s 46 will apply. In order to comply with State aid rules, restrictions apply, and certain businesses will not be able to claim the FYA. In addition, the amount of expenditure qualifying for the new FYA is limited to 85m euros per undertaking (for example a group of companies) over the 5-year period.

Film Tax Relief

For film production companies making films whose production spans 2 or more accounting periods and which have some overseas expenditure the loss that is currently surrendered for tax credit is the lesser of the available qualifying expenditure (cumulative qualifying expenditure to date, less any previously surrendered amount), and the loss incurred in that period. However, where there is an increased UK spend in the second or later periods there is an unintended effect and this is to restrict the amount of tax credit claimable.

This anomaly is now to be corrected by the way the amount that can be surrendered for tax credit is calculated. The calculation will become the lesser of:

- the available qualifying expenditure; and
- the loss for the period, plus any loss brought forward which has not been surrendered.

This measure has effect for accounting periods ending on or after 9 December 2009 and is to be treated as always having had effect for those periods.

Bank Levy

The Government will introduce a levy based on banks' balance sheets from 1 January 2011. This is intended 'to encourage banks to move to less risky funding profiles'. The final details of the levy will be published later this year, following consultation. It is proposed that it will be set at a rate of 0.07%, with a lower initial rate of 0.04% in 2011.

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Furnished Holiday Lettings

The Government has announced that the reliefs for furnished holiday lettings will not now be withdrawn from April 2010 as had previously been proposed. The existing arrangements under which the rules are extended to lettings situated in the European Economic Area will continue to apply for 2010/11.

A public consultation will be carried out about changes to the tax treatment from April 2011. The consultation will specifically consider proposals to increase the number of days for which properties must be let and to change the way in which relief for losses is given. Draft legislation will be published in autumn 2010 with a view to inclusion in the 2011 Finance Bill.

CORPORATION TAX

Main Rate

The main rate of corporation tax for companies with profits above the upper limit of £1.5m will be reduced to 27% from 1 April 2011. There will be further reductions to 24% by 1 April 2014. The main rate for companies with profits arising on and after 1 April 2011 from oil extraction and oil rights in the UK and the UK Continental Shelf (ring-fence profits) will remain at 30%.

Small Profits Rates

For companies with profits below the lower limit of £300,000, the small profits rate of corporation tax will be reduced to 20% from 1 April 2011. The small profits rate for companies with profits arising on or after 1 April 2011 from oil extraction and oil rights in the UK and the UK Continental Shelf (ring-fence profits) will remain at 19%.

Worldwide Debt Cap

The autumn Finance Bill will include 14 separate changes to the worldwide debt cap regime. Most of these have been previously announced, following consultation with business. The changes are intended to ensure that the provisions operate as originally intended. Companies within the special corporation tax regime for securitisation companies will be excluded from the main debt cap rules. This will include the exclusion of their financing expenses when computing the worldwide group’s cost of finance. There will also be a power to make regulations to enable companies involved in capital market arrangements to transfer any additional tax liability incurred as a result of the debt cap regime to another company in the group.

Consortium Relief

Two changes are to be made to the consortium relief rules. The changes are to be included in a Finance Bill to be introduced after the summer recess and will apply for accounting periods beginning on or after the date the legislation is published.

The first change extends the link company rule, under which a consortium member can transfer its share of the consortium’s losses to a member of its group, so that a company established within the European Economic Area can be a link company.

The second change is to the rule for determining the maximum amount of losses that can be claimed from a consortium company. Currently, the maximum is determined by the lowest result from 3 tests. A fourth test is to be added based on the proportion of voting rights and the extent of control the member holds in the consortium.

Capital Distributions

Legislation will be introduced to clarify the treatment of certain distributions received by UK companies. Essentially the provisions will confirm HMRC’s existing practice of treating all UK distributions as being of an income nature unless they are specifically excluded. The legislation will have retrospective effect (although companies can elect for the legislation not to apply retrospectively).

Research and Development Tax Relief

The current conditions under which small or medium-sized enterprises can claim enhanced tax relief for expenditure on research and development include a requirement that any intellectual property deriving from the research and development to which the expenditure is attributable must be owned

by the company making the claim. This requirement will be abolished. The abolition will have effect for any expenditure incurred by an SME company on research and development in an accounting period ending on or after 9 December 2009.

Oil and Gas Fiscal Regime

Finance Act 2009 included several measures to provide support for investment by oil and gas companies operating in the UK or on the UK Continental Shelf. These included a provision that chargeable gains would not arise in some circumstances where the disposal proceeds were reinvested in new oil trade assets, and the disposal and acquisition qualified for rollover relief. The scope of this reinvestment relief will be widened so that it can apply when proceeds are reinvested in exploration and development expenditure, including drilling costs, and can apply as intended in a group context when the company making the reinvestment is not the company making the disposal. These changes will have retrospective effect, to 24 March 2010 and 22 April 2009 respectively.

In addition, the scope of the measure providing that in certain circumstances chargeable gains do not arise on the swap of UK/UKCS licences will be widened. The scope of the 'field allowance' will be extended to investment in fields that have previously been decommissioned, with retrospective application to fields whose development was authorised on or after 22 April 2009. The qualifying criteria for a high pressure/high temperature field will be reduced, and the allowance will be tapered, by means of an order which will be introduced before 29 July 2010, and will come into force on the day after the date on which it is made.

Life Insurance Companies

A number of measures are to be introduced to amend the tax regime for life insurance companies, with effect from various dates. The measures will amend the rules applying where insurance business carried on in the UK is transferred to a non-European Economic Area (EEA) overseas company or to a UK branch of a company resident elsewhere in the EEA. It is also confirmed that an anti-avoidance rule announced in the March Budget which prevents manipulation to avoid tax on previously unrecognised profits will be introduced in the Finance Bill.

Interest Harmonisation: Corporation Tax and Petroleum Revenue Tax

Corporation tax and petroleum revenue tax will be brought within the harmonised interest regime introduced in Finance Act 2009. The new harmonised interest provisions will replace the current range of differing regimes with a single legislative framework for interest chargeable on late payments and payable on repayments and this will apply to all taxes and duties administered by HMRC. Interest will be charged from the date the tax or duty was due to be paid to HMRC until the date it is paid. HMRC will pay interest on repayments from the date the tax or duty was due to be paid or, if later, the date the payment was actually received, to the date the repayment is made. The statutory description of interest for each of these taxes will be 'late payment interest' and 'repayment interest'. Interest harmonisation will be phased in over a number of years and the dates from which these changes take effect will be specified by Treasury orders. The rules for Quarterly Instalment Payments remain unchanged and do not form part of the harmonised rules that will apply to corporation tax.

CAPITAL GAINS TAX

Rates and Entrepreneurs' Relief

New rates of capital gains tax (CGT) are introduced with effect for gains arising on or after 23 June 2010. For individuals, a new higher rate of 28% applies where total taxable income and gains are more than the upper limit of the basic rate income tax band (currently £37,400). The higher rate applies to any gains or parts of gains which exceed the limit. Where total taxable income and gains do not exceed the limit, gains remain taxable at 18%.

For trustees and personal representatives, the higher 28% rate applies to all taxable gains arising on or after 23 June 2010.

Gains arising in 2010/11 but before 23 June 2010 are liable to CGT at 18% and are not taken into account in determining the rates which apply to gains made on or after that date.

Changes are also made to entrepreneurs' relief to ensure that gains on qualifying disposals on or after 23 June 2010 are taxed at a rate of 10%. The lifetime limit for entrepreneurs' relief is increased to £5m with effect for gains made on or after the same date. In determining the rate at which an

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individual pays CGT on other gains, gains qualifying for entrepreneurs' relief are set against any unused basic rate band before non-qualifying gains.

An individual can deduct allowable losses and the annual exempt amount from gains in the way which minimises the tax due.

Principal Private Residence Relief and Adult Placement Carers

Where a person cares for an adult under a local authority placement scheme, their contract with the local authority may require them to set aside one or more rooms exclusively for the use of the adult in care. In such a case, TCGA 1992, s 224 can prevent the CGT exemption on the individual's principal private residence relief being available on that part of the property.

The legislation will remove this possible restriction so the fact that part of the home is occupied by the adult in care will not prevent CGT relief being available on that part.

This change will have effect for disposals on or after 9 December 2009.

SAVINGS AND INVESTMENTS

Enterprise Management Incentives

To ensure that the enterprise management incentive (EMI) share option scheme complies with EU State aid guidelines, legislation will be introduced in a Finance Bill as soon as possible after the summer recess to remove the need for a company granting EMI options to operate wholly or mainly in the UK. Instead, the company will only need to have a permanent establishment in the UK. In the case of a parent company, at least 1 company in the group that is carrying on a qualifying trade must have a permanent establishment in the UK.

A company has a permanent establishment in the UK if it has a fixed place of business in the UK through which the business of the company is wholly or partly carried on, or it has an agent in the UK who exercises authority to do business on behalf of the company.

This will have effect in respect of EMI share options granted on or after the date that the legislation receives Royal Assent.

Venture Capital Schemes

Changes will be made to the rules on enterprise investment schemes (EIS) and venture capital trust (VCT) schemes to comply with European Commission requirements on State aid.

Legislation to be included in a Finance Bill to be introduced as soon as possible after the summer recess will:

- exclude any 'enterprise in difficulty' from qualifying for investment under the rules for EIS or VCT schemes;
- remove the condition in both schemes that the qualifying trade must be carried on wholly or mainly in the UK and replace it with a requirement that the company issuing the shares has a permanent establishment in the UK. The definition of 'permanent establishment' will be based on Article 5 of the OECD Model Tax Convention on Income and Capital.

The term 'enterprise in difficulty' takes its meaning from the European Commission's Rescue and Restructuring Guidelines.

The legislation will also make the following changes applicable only to VCT schemes:

- at least 70% of the VCT's qualifying holdings will have to be holdings of eligible shares (an increase from the current 30% minimum);
- the definition of eligible shares will be expanded to include shares which may carry certain preferential rights to dividends;
- the ordinary share capital of the VCT must be tradable on any EU regulated market (rather than only being included in the official UK list as at present).

All these changes will have effect on or after a date to be appointed. The 'eligible shares' changes for VCTs will not affect the investment of monies raised by a VCT before that commencement date. The

'permanent establishment' condition for both EIS and VCT schemes will apply to shares issued on or after the commencement date.

UK Real Estate Investment Trusts and Stock Dividends

The rules on distributions by UK Real Estate Investment Trusts (REITs) are to be relaxed. Currently, in order to meet the conditions to qualify as a REIT, the company (or group of companies) must distribute at least 90% of the profits from its rental business to its shareholders by way of a cash dividend. Under the new rules, any stock dividends issued by the REIT to its shareholders will also be included to determine if 90% of the profits have been distributed. The legislation will be included in a Finance Bill to be introduced as soon as possible after the summer recess, and will have effect for property income distributions made on or after the date of Royal Assent.

Indexing Individual Savings Account Limits from 2011

With effect from 6 April 2011 the ISA limits will be increased in line with the Retail Prices Index (RPI) on an annual basis. The limits will then be rounded to a convenient multiple of 120, to facilitate calculation of a monthly savings figure.

The new limits will be calculated by reference to the RPI for the month of September before the start of the following tax year, e.g. the limit for 2011/12 will be set by reference to the RPI in September 2010. If the RPI is negative, the ISA limit will remain unchanged. HMRC will announce the new limits in advance of the start of the new tax year in which they apply.

The cash ISA limit will remain half the stocks and shares limit, e.g. for 2010/11, the cash ISA limit is £5,100, the stocks and shares ISA limit is £10,200.

Pensions Tax Relief

Finance Act 2010 included legislation to restrict relief given at above the basic rate on pension provision for 2011/12 onwards by high income individuals. The new Government is to continue with this plan for the time being, but will also be considering, in consultation with interested parties, possible alternative means of raising the same tax revenue. One alternative would be to significantly reduce the pension annual allowance (currently £255,000) to somewhere in the range of £30,000 to £45,000. The Government is to include powers in the next Finance Bill to repeal the legislation contained in Finance Act 2010; it should be noted that this is not to say the legislation will, in fact, be repealed.

Deferral of Maximum Age to Purchase Pension Annuity to 77

The Government is to end the requirement to use a pension fund to buy an annuity by age 75, with effect from 2011/12.

The change will be effective from 22 June 2010 for pension scheme members who are under age 75 at that date.

Income drawdown limits which now apply from age 75, will in future apply from age 77; and IHT charges currently applicable when scheme members die on or after their 75th birthday will also be affected.

The Government will consult on the changes and will introduce transitional measures for those reaching age 75 before the new rules are finalised.

National Employment Savings Trust

As announced in the March 2010 Budget, the National Employment Savings Trust (NEST) will be allowed to register as a pension scheme with HMRC, allowing the members and their employers to benefit from tax relief on contributions and investment growth.

The change will be included in the autumn Finance Bill and will be effective from the date the Bill receives Royal Assent.

TRUSTS

Tax Repayments on Settlor-Interested Trusts

New legislation to be introduced in a Finance Bill as soon as possible after the summer recess will require settlors of settlor-interested trusts to pay any tax refunds they receive on the trust income to the trustees. These repayments will be disregarded for inheritance tax purposes. The rule will apply to repayments relating to trust income arising on or after 6 April 2010.

Trust for Asbestos Victims

This measure will exempt trustees of trusts set up to pay compensation to asbestos victims from capital gains tax, inheritance tax and income tax. The trusts that will benefit are those set up on or before 23 March 2010 as part of an arrangement made by a company with its creditors and specifically to pay compensation to, or in respect of, individuals with asbestos-related conditions. The exemption will have backdated effect from 6 April 2006.

Previously, trustees would have been subject to IHT charges every 10 years (periodic charges) on the value of property held in trust above the IHT nil rate band (currently £325,000) and also on certain payments made out of the trust (exit charges). Trustees have also been liable to income tax on income arising to the trust, and CGT on disposals of certain trust assets. This new measure provides for exemptions from the IHT, CGT and income tax charges on the trustees of these types of trusts. For the exemptions to apply, the trust must also be specifically for the purpose of paying compensation to, or in respect of, individuals with asbestos-related conditions.

The legislation will be included in a Finance Bill to be introduced as soon as possible after the summer recess.

ANTI-AVOIDANCE

Corporation Tax Avoidance: Authorised Investment Funds

Legislation will be introduced, with effect from 22 June 2010, to ensure that a corporate investor cannot make use of an authorised investment fund to create a credit for UK tax where no UK tax has been paid. The corporation tax deduction given for interest distributions will be restricted so that the deduction is reduced to the extent that the distribution is derived from dividends that are exempt from corporation tax. Additionally, where foreign tax is suffered by an authorised investment fund, the deemed tax credit in the hands of the corporate investor will be treated as a foreign tax credit for all tax purposes (and a proportionate part of the income will be treated as foreign income).

Loan Relationships

The summer Finance Bill will include legislation intended to tackle avoidance schemes under which the profits arising to a company from a financial asset have been claimed to fall out of account for tax purposes as a result of the 'derecognition' of a loan or derivative. This will have effect for credits and debits arising on or after 22 June 2010. The legislation will extend the circumstances in which amounts are to be fully recognised for tax purposes, to include cases where derecognition arises as a result of the acquisition or variation of a capital interest in a company, partnership or trust, or where derecognition is triggered by an event that occurs in a later accounting period to that in which the derecognition takes place.

STAMP TAXES

Overpayments of Stamp Duty Land Tax and Petroleum Revenue Tax

The error or mistake relief rules relating to stamp duty land tax and petroleum revenue tax will be amended with effect from 1 April 2011. The time limit for claiming repayments will be reduced from 6 years to 4 years. The requirement that the overpayment must be the result of a mistake in a return, and that it must be made under an assessment, will be removed. The current restrictions on the right of appeal will also be removed. These changes will bring the rules for these taxes into line with those already applying for income tax, capital gains tax and corporation tax.

VALUE ADDED TAX

Increase in the Standard Rate

With effect from 4 January 2011, the standard rate of VAT will rise from 17.5% to 20%. There will be no changes to the scope of zero-rating, reduced-rating, or exemption.

Change in the Standard Rate – Anti-Forestalling Measures

The summer Finance Bill will include provisions to counter schemes that purport to apply the 17.5% rate of VAT to goods or services delivered or performed on or after 4 January 2011, the date on which the standard rate increases to 20%. The legislation will provide that, in certain circumstances, a supplementary VAT charge of 2.5% will be due on supplies of goods or services on which VAT has been declared at 17.5%. This charge will apply where the customer cannot recover all the VAT on the supply and one of the following conditions is met:

- the supplier and customer are connected parties;
- the supplier, or someone connected with him, funds a prepayment;
- an advance VAT invoice is issued where payment is not due in full within 6 months (except for hire purchase invoices issued in accordance with normal commercial practice);
- the value of the supply (and any related supplies) exceeds £100,000 (this does not apply if a prepayment, or the issue of an advance VAT invoice, is normal commercial practice).

The supplementary charge will not apply to prepaid or invoiced rentals of land, buildings or other assets if the period concerned does not exceed 1 year and the payment or invoicing method is normal commercial practice.

The supplementary charge will also apply to rights and options. The legislative provisions will have effect for transactions on or after 22 June 2010.

Changes to the Flat Rate Scheme

The rates applicable to businesses using the VAT flat rate scheme will be recalculated with effect from 4 January 2011, to reflect the increase in the standard rate of VAT to 20%.

The exit threshold (i.e. the level of turnover beyond which a business is required to leave the scheme) is increased from £225,000 to £230,000. Where the increase is due to a one-off transaction, a business may remain in the scheme if it expects its turnover in the subsequent year to be less than a specified amount, which will rise from 4 January 2011 from £187,500 to £191,500.

Change to Zero-Rating of Qualifying Aircraft

The definition of aircraft which may be supplied at the zero rate will be amended with effect in relation to supplies made on or after 1 January 2011. From that date, zero-rating will apply to supplies of aircraft 'used by airlines operating for reward chiefly on international routes'. (The current definition refers to aircraft weighing not less than 8,000kg, and neither designed nor adapted for recreation or pleasure.)

This change is to bring UK legislation into line with EU legislation.

Gas, Heat and Cooling

With effect from 1 January 2011, the application of the reverse charge to certain supplies of gas and electricity will be extended to supplies in all categories of natural gas pipeline, where the pipeline is situated in the EU or is linked to such a pipeline. The reverse charge will also apply to heat and cooling supplied through networks.

In addition, the import VAT relief (in the form of zero-rating) will apply to all natural gas, heating and cooling imported via a network (including liquefied natural gas by tanker).

Postal Services

With effect from 31 January 2011, the exemption for supplies of postal services by Royal Mail will be restricted to those services which are made under a licence duty, i.e. public postal services and incidental goods. Other services (such as those made by Parcelforce) will become standard-rated.

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Changes to Lennartz Accounting

The Lennartz procedure, under which a business may initially recover VAT in full on the purchase of an asset even where there is an element of non-business use, is to be changed. Amendments to VATA 1994 will:

- distinguish between business input tax and non-business VAT;
- ensure that VAT is not recoverable on the private or non-business use of specified assets;
- provide a power to treat non-business VAT as input tax;
- ensure that VAT on the private use of directors' accommodation is not recoverable.

The capital goods scheme will be amended to take into account changes in the business/private use of an asset.

As a revenue protection measure, output tax will continue to be due in respect of supplies for which credit was allowed under the Lennartz mechanism.

The changes will, for the most part, apply from 1 January 2011, with the proviso that the revenue protection measure will be deemed always to have had effect.

INSURANCE PREMIUM TAX

Increase in the Standard and Higher Rate

The standard and higher rate of insurance premium tax (IPT) will increase to 6% and 20% respectively with effect from 4 January 2011. For insurers who use the cash receipt method to account for IPT, the new rates will have effect for premiums received under taxable insurance contracts on or after 4 January 2011. For insurers who account for IPT using the special accounting scheme the new rates will have effect for premiums that are written into their records as due to them on or after 4 January 2011.

ENVIRONMENTAL TAXES

Lower Rate of Landfill Tax

Legislation in the autumn Finance Bill will include a measure to provide for the publication and review of criteria for determining the lower rate of landfill tax. The materials which qualify for the lower rate will be listed in a Treasury order, which will come into force on 1 April 2011.

Aggregates Levy: Northern Ireland Credit Scheme

The Northern Ireland aggregates levy credit scheme has been extended for a further 10 years. The scheme allows certain aggregate producers in Northern Ireland an 80% tax credit. State aid approval from the EU Commission is required for the extension of the scheme.

EXCISE DUTIES

Tobacco Products Duty: Long Cigarettes

The Tobacco Products Duty Act 1979 details how tax is calculated on 'long cigarettes' (i.e. those longer than 8cm, excluding any filter) and when they are deemed to be more than 1 cigarette. The autumn Finance Bill will include a measure which will change the basis on which duty is calculated on such cigarettes. In the case of cigarettes longer than 8cm (excluding any filter), each additional 3cm (or part thereof) will be treated as an additional cigarette for the purposes of the calculation of duty. For example, a cigarette of 12cm would be treated as 3 cigarettes.

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MISCELLANEOUS

Further Changes

The Government has announced that the following proposals will be withdrawn:

- a tax relief for the video games industry;
- a duty on fixed landlines;
- the Gateway Savings Account.

The proposed introduction of Managed Payment Plans, which would allow taxpayers to pay self-assessed income tax and corporation tax in a series of monthly instalments either side of the theoretical due date, will be deferred.

Finance Acts

It has been confirmed that there will be three Finance Acts this year.

No 1 has already received Royal Assent pre election.

No 2, had first reading on Monday 28th June, the bill will be published on 1 July 2010 and the aim is for it to receive Royal Assent before the summer recess, so end of July.

No 3, a draft bill will be published before the summer recess, first reading will be after the summer recess, with Royal Assent before Christmas.

Lecture P601 (14.20 Minutes)

Personal Tax

Pensions –restriction of higher and additional rate relief from 6 April 2011

As originally announced last year, higher and additional rate relief for individuals whose income exceeds £180,000 is to be removed altogether after 5 April 2011 so that they will only receive basic rate relief on their pension contributions (subject, of course, to the annual and lifetime allowances).

Individuals with incomes between £150,000 and £180,000 will still enjoy some element of higher and additional rate relief, but it will be progressively tapered away as their income approaches the upper limit.

The legislation to enact this restriction is set out in S23 and Sch 2 FA 2010 which inserts new Ss213A – 213P FA 2004. This creates a new tax known as a 'high income excess relief charge'. As stated in the Budget section above, the coalition government are keen to simplify these rules but it is by no means certain that these rules will be replaced by something more straight forward.

As previously proposed the restriction will apply to taxpayers whose 'gross income' is £150,000 or more. This term is defined in S213C FA 2004. 'Gross income' for the purposes of the £150,000 threshold includes all contributions made by or on behalf of the individual. The rationale for this rule can be explained by a simple example. Anderson has a salary of £145,000 and, in addition, receives an employer pension contribution of £25,000. Baldwin has a salary of £170,000 out of which he makes a £25,000 payment for a personal pension – he is not entitled to an employer contribution. In each case, the full value of the individual's remuneration package is £170,000 from which a £25,000 pension contribution is made. However, if the definition of 'gross income' did not include employer pension contributions, the higher and additional rate restriction would apply to Baldwin but not to Anderson (even though their overall remuneration and pension arrangements are identical).

Notice that an individual's residence, ordinary residence and domicile status is irrelevant in this context (see S213A(3) FA 2004). If they have sufficient 'gross income', they will be caught.

In addition, there is an income floor of £130,000 so that anyone whose pre-tax income after adding back their pension contributions and charitable donations is less than £130,000 will not be affected and will therefore still benefit from full tax relief. For this test, employer contributions are *not* included. Note that the legislation does not use the conventional total income definition ('adjusted net income') which permits various deductions to be taken into account, since this would allow individuals, in HMRC's words, to 'manipulate their income by making additional pension contributions or charitable donations with the aim of circumventing the restriction of relief'. This is known as the 'relevant income' calculation (S213D FA 2004).

Illustration 1

Clarke has a salary of £200,000 and is a member of his company's occupational pension scheme with a 5% employee (£10,000) and a 10% employer (£20,000) contribution. His income is above the 'relevant income' floor referred to in (f) above at £200,000 and, with a 'gross income' of £220,000, he will be affected by the restriction of tax relief on the £30,000 contributions made.

Illustration 2

Cripps has a salary of £115,000 and rental income of £12,000. He receives a pension benefit of £30,000 from his employer. Given that his income is below the 'relevant income' floor of £130,000, he is not subject to the restriction of tax relief on pension contributions, despite the fact that his 'gross income' is £157,000.

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In this context, one commentator has remarked:

> 'The £130,000 floor is intended to reduce the administrative burden on schemes by enabling them to identify more easily those who are definitely not affected by the new rules.'

To sum up the position so far, the new legislation will apply to 'high income' individuals, that is to say, any individual whose:

- 'gross income' for the tax year is £150,000 or more; and
- 'relevant income' for the tax year is not less than £130,000.

Tax relief for such individuals will be restricted by means of the 'high income excess relief charge' referred to above which will be self-assessed and which will effectively claw back the taxpayer's excess higher and additional rate relief.

This will be achieved by the application of what S213E FA 2004 calls 'the appropriate rate' to the individual's total pension savings for the tax year. The 'appropriate rate' is:

- 20% in relation to so much of the individual's pension savings as, when added to their taxable income for the year, does not exceed the higher rate limit of (currently) £150,000; and
- 30% in relation to so much of the individual's pension savings as, when so added, exceeds the higher rate limit.

As usual, a taxpayer's higher rate limit will be extended by the gross amount of any Gift Aid donations and relief at source pension contributions.

Illustration 3

In 2011/12, Chamberlain has employment income of £250,000 and savings income of £18,000. During that year, he makes a £40,000 net contribution to his personal pension scheme. He also makes a cash donation of £2,000 to his favourite charity under Gift Aid.

For the purpose of determining Chamberlain's higher rate limit, both the pension contribution and the Gift Aid donation must be grossed up by 20%. The pension contribution becomes £50,000 (£40,000 x 100/80) and the Gift Aid donation becomes £2,500 (£2,000 x 100/80). Thus Chamberlain's higher rate limit for 2011/12 is £150,000 + £52,500 = £202,500.

Illustration 4

In 2011/12, Callaghan has a salary of £156,000. He has no other taxable income. He makes a £12,000 contribution to his employer's occupational pension scheme and his employer puts in a further £25,000.

Callaghan's total pension savings come to £37,000. His 'gross income' is £156,000 + £25,000 = £181,000. He is therefore subject to a full 'high income excess relief charge'.

Callaghan's taxable income is £156,000 – £12,000 = £144,000 (he is not entitled to a personal allowance). The difference between this figure and his higher rate limit – assumed to be £150,000 – is £6,000. Thus £6,000 is liable at 20% and the excess pension savings amount of £31,000 (£37,000 – £6,000) is liable at 30%.

This gives Callaghan a 'high income excess relief charge' of £1,200 + £9,300 = £10,500.

One of the elements used to determine the quantum of any 'high income excess relief charge' is the individual's total pension savings amount. A taxpayer may have rights under a number of different arrangements and, for any tax year, his total pension savings amount is the aggregate value of the

benefits from all his schemes. These are measured in a variety of different ways, using a method which depends on the particular arrangement.

There are separate rules for:

(i) money purchase arrangements;
(ii) defined benefit arrangements;
(iii) cash balance arrangements; and
(iv) hybrid arrangements.

For example, with money purchase arrangements, the pension savings amount is usually the total of the member's relievable pension contributions paid by him during the tax year in question together with any contributions paid on his behalf by his employer. A detailed consideration of all the permutations is beyond the scope of these notes, but further information can be found in HMRC's technical guidance on the 'high income excess relief charge' which is available on their website – see also Ss213F – 213N FA 2004.

In Illustration 4 above, the taxpayer's 'gross income' was £181,000 and he was therefore subject to the full charge. However, where an individual's 'gross income' is between £150,000 and £180,000, the appropriate rate is tapered by 1% for every complete £1,000 by which his 'gross income' is less than £180,000 (S213E(2) FA 2004). For example, if a taxpayer has a 'gross income' of £173,600, this falls into the £173,001 – £174,000 bracket. This is £6,000 below the upper limit and so the taper percentage is 6%, giving an appropriate rate for a 50% taxpayer of 30% – 6% = 24%. The appropriate rate can never be reduced to less than 0%! There is a further example in (q) below.

Illustration 5

Churchill's earnings for 2011/12 are £135,000. He has no other income and he does not pay any pension contributions himself. However, his employer makes a contribution of £20,000 to his pension fund which is a money purchase arrangement.

Churchill's total pension savings come to £20,000. His 'gross income' is £135,000 + £20,000 = £155,000. He is therefore subject to a tapered 'high income excess relief charge'. He falls into the £154,001 – £155,000 bracket and so his taper percentage is 25%. Because his 'gross income' is £155,000, he has £5,000 for which the appropriate percentage (before taper) is 30% and £15,000 for which the appropriate percentage (before taper) is 20%.

The higher rate limit is again assumed to be £150,000. After taper, Churchill's position is:

(i) £5,000 @ 5%; and

(ii) £15,000 @ 0%,

giving a 'high income excess relief charge' of £250.

It is understood that, where the 'high income excess relief charge' exceeds £15,000, the individual will have the option of asking the scheme to pay it out of the pension fund as an alternative to paying it himself as part of his self-assessment final liability.

It is important to appreciate that the restriction in FA 2010 applies to *all* the pension savings of an individual. This is unlike the anti-forestalling legislation which only catches 'irregular' payments. Also, when considering an individual's 'gross income' for a particular tax year, it is never going to be necessary to examine the position for a previous tax year. Thus someone whose income fluctuates from year to year can fall in and out of the rules.

The Government have confirmed that, as of 6 April 2010 and for a further five tax years up to and including 2015/16, the annual allowance for pension contributions will remain at £255,000 and the lifetime allowance at £1,800,000. This was first announced in the 2008 Pre-Budget Report.

Contributed by Robert Jamieson

Lecture P602 (24.06 Minutes)

More on ordinary residence

Tuczka v HMRC (2010)

The *Tuczka* case deals with a particular aspect of residence. Dr Tuczka, who was Austrian, was not leaving the UK in order to establish non-UK residence. He arrived in the UK to work here for a short period and became UK-resident – the only question for determination was whether, and when, he became ordinarily resident in the UK.

This question is important because an individual who is resident but not ordinarily resident in the UK is liable to tax on the full amount of his UK earnings, but his earnings from abroad are only taxable on the remittance basis. If, however, he is resident and ordinarily resident in the UK, he is assessable on the whole of the earnings from his employment, irrespective of how much or how little of those earnings were generated in the UK.

Unfortunately, the judgment in this case has thrown the subject into complete confusion. Hitherto it had been generally understood that, when someone comes to the UK, they do not become ordinarily resident here until the third anniversary of their arrival. This had been the HMRC practice for many years and, in *Genovese v HMRC (2009)*, the Special Commissioner held that the law was in line with their practice. A period of three years, he confirmed, was sufficient to establish the habitual nature of a person's presence which was an essential prerequisite for ordinary residence.

However, the same Special Commissioner (now a Judge of the First-Tier Tribunal) has heard the case of Dr Tuczka, whose circumstances were similar to those dealt with in the *Genovese* case, and he has decided that his earlier references to a three-year period were wrong!

The latest position has been summarised by one commentator as follows:

> 'What is needed to establish ordinary residence is voluntary residence in the UK and being here for a settled purpose. The intention of the taxpayer is largely irrelevant. The crucial element is that they are here for settled purposes. One of those purposes is employment. Dr Tuczka came to the UK to work and, although he had only intended to be here for two and a half years or so, his intentions and plans to depart were disregarded. What was important was his purpose. Because he came here to work, that was a settled purpose and he became ordinarily resident very soon after his arrival in the UK.
>
> The decision shows that there is a very narrow distinction (or perhaps no distinction at all) between residence and ordinary residence. So, if a person becomes resident in the UK and takes up employment here, he will become ordinarily resident almost immediately on his arrival – even if his intention is not to stay very long.'

This 'clarification' of the law on ordinary residence will be viewed with alarm by employees coming to work in the UK as well as by those who have recently arrived in the UK and who have acted in accordance with advice on HMRC's normal practice.

If they are resident and ordinarily resident in the UK, they will be liable to tax on the whole of their worldwide employment income instead of (as they expected) simply having to pay tax on the earnings attributable to their UK duties.

They will now become ordinarily resident much earlier than they could have anticipated and will be exposed to a much higher liability to tax.

The fact that this recent decision is contrary to the previous ruling in *Genovese v HMRC (2009)* and contrary to HMRC's guidance means that some more detailed explanation is urgently required. Either the guidance from HMRC needs to be changed or the law needs to be changed, perhaps by another case or (more likely) by the introduction of a statutory residence test. In the meantime, the uncertainty which has arisen regarding individuals attempting to leave the UK and become non-UK resident has now been matched by the confusion over the ordinary residence status of those coming to the UK.

Turberville v HMRC (2010)

Another case which has recently been heard by the First-Tier Tribunal on ordinary residence is *Turberville v HMRC (2010)*. However, anyone hoping that the decision would provide some urgently needed clarity to the uncertainty created by the contradictory cases of *Genovese v HMRC (2009)* and *Tuczka v HMRC (2010)* is in for a disappointment. From one perspective, one might not have expected too much illumination to be shed given that this latest case was not dealing with a taxpayer coming to the UK but rather concerned someone leaving the UK and seeking to become ordinarily resident elsewhere. Having said that, the question then arises as to whether there is some consistency with the outcome of *Gaines-Cooper v HMRC (2010)*, but sadly that is not the case.

Mr Turberville was a chartered accountant based in Scotland. In 1979, he joined Shell and left the UK to work in various international locations. He returned to London in February 1997 and began living in the UK again. Throughout the period of his absence, he owned houses in the UK. In July 2001, he took a senior post with a company called TXU in Dallas. Regrettably, the fortunes of TXU declined and he was made redundant on 31 October 2002. He returned to one of his UK properties and made arrangements to move to Monaco. As a result of the change in his circumstances, he spent 118 days in the UK in 2002/03. The question for determination was whether he was ordinarily resident here for that tax year.

HMRC argued that he had been resident and ordinarily resident in the UK until July 2001 and that nothing had changed thereafter. He had always owned a home in the UK and only had temporary absences with frequent visits to his properties here. Although Mr Turberville worked abroad for more than a year from July 2001 until the end of October 2002, this did not span a complete tax year.

Mr Turberville, on the other hand, contended that there was a complete break in his lifestyle when he went to Dallas under a contract which was intended to last for the next three years and with the expectation that he would then take over as chairman of TXU and remain there until his retirement.

The Tribunal decided that, when Mr Turberville left the UK in July 2001, his three-year contract (and the refurbishment which he undertook to the Dallas apartment rented by his employer) both pointed to a distinct break. His expectation of being appointed chairman reinforced the position. These facts demonstrated a distinct break in his lifestyle, which meant that he ceased to be ordinarily resident in the UK. However, just as happened in the *Genovese* case, it was not open to the Tribunal to split the tax year and therefore he could not have terminated his ordinary residence status here until the end of the tax year in which he departed for the USA.

However, for 2002/03, the Tribunal ruled that he was not ordinarily resident in the UK. He lost his job in Dallas at the end of October 2002 and it did not seem to matter that he returned to the UK to work for a short time – he was busy arranging an apartment in Monaco and that is where he intended to live for the foreseeable future. This was an interesting observation given that the whole thrust of the decision in *Tuczka v HMRC (2010)* was that intention was irrelevant! The Tribunal considered that the retention of his house and flat in the UK was a neutral point. The Judge did not think that the premature end to his employment and the resumption of his presence in the UK caused him to become ordinarily resident here. The leasing of the property in Monaco, the acquisition of a *carte de séjour* there (involving, as it did, five trips between the UK and Monaco) and the drive to Monaco in January 2003 all meant that it was not possible to say that he had a regular order of life anywhere – it was a time of transition. The UK was not his residence for settled purposes as part of the regular order of his life and his physical presence was no more than a stop-gap measure. Accordingly, he was not ordinarily resident in the UK for 2002/03.

It is instructive to read the Tribunal's views regarding what constitutes a distinct break because it certainly seems to conflict with the Court of Appeal's decision in the *Gaines-Cooper* case which stated that a distinct break requires the severance of all the taxpayer's family and social ties in the UK. Mr Turberville's mother lived here, he had two homes here, he worked here and was in the UK for 118 days (plus a further 22 days in connection with his mother's funeral). Whatever interpretation one might give to the phrase 'severing all family and social ties', it surely cannot include these circumstances.

One commentator summed up the position as follows:

> 'There is so much in this case which is inconsistent (and sometimes in direct conflict) with recent authorities that it just highlights the confusion over the whole subject. There is an urgent need for clarification in this area.'

Contributed by Robert Jamieson

Lecture P603 (18.48 Minutes)

Capital Gains Tax

Foreign tax credit relief and chargeable gains

On 19 March 2010, HMRC issued Revenue & Customs Brief 17/10 to publicise a change in their established practice of restricting, in certain circumstances, the amount of foreign tax credit relief which can be deducted when calculating the UK tax due on a capital gain.

When a gain is chargeable to CGT or corporation tax in the UK and the same gain is also taxable in another jurisdiction, foreign tax credit relief can be claimed in respect of the tax paid overseas (see, for example, S278 TCGA 1992).

Hitherto, HMRC's practice has been to limit the amount of foreign tax credit relief if:

- different periods of ownership of the asset are considered when arriving at the quantum of gain assessable in the UK and gain assessable abroad; or
- the taxable amount of the UK gain is less than that of the foreign gain.

New practice

However, HMRC now say:

> 'We have reconsidered our view and are revising our practice so that the whole of the foreign tax is allowable as foreign tax credit relief up to the amount of UK tax on the gain.'

Illustration

Snowden acquired a foreign asset on 31 March 1975 and sold it on 31 March 2010. The foreign tax charged was £18,000.

Because rebasing would be in point for an asset acquired prior to 31 March 1982, HMRC's practice was to restrict the foreign tax credit relief by the following amount:

$$\frac{31.3.82 - 31.3.10}{31.3.75 - 31.3.10} \quad \text{x} \quad \text{Foreign tax}$$

This produces 28/35 x £18,000 = £14,400. However, provided that the UK tax charge is at least £18,000, full foreign tax credit relief will now be given.

Similarly, if a taxpayer had a gain which was assessed in the UK in the sum of £55,000 but the taxable amount of the gain overseas was £75,000 (with a foreign tax liability of £9,000), the foreign tax credit relief would have been limited to 55,000/75,000 x £9,000 = £6,600. With effect from 19 March 2010, the whole of the foreign tax will be allowable up to the amount of the UK tax on the gain.

This change brings the practice for chargeable gains into line with the principles used for income tax.

Implications for submitted returns

Those returns which are still open or within the self-assessment window for amendment can be corrected to reflect the change of practice.

In other cases, where foreign tax credit relief has been restricted, a claim can be made for additional relief within the usual time limits. Until recently, these were five years and 10 months for claims and assessments involving income tax and CGT and six years where corporation tax was in point.

However, following changes announced in 2008, there is now a standard time limit of four years from the end of the tax year for making repayment claims for income tax and CGT and four years from the end of the accounting period for corporation tax purposes.

These rules took effect on 1 April 2010. Thus a claim for overpaid CGT relating to 2004/05 would have to have been made before 1 April 2010 and a similar claim for 2005/06 would have to have been made before 6 April 2010.

Because the publication of Revenue & Customs Brief 17/10 left so little time for claims to be made within the revised statutory time limits, HMRC have said that they will accept late claims for the tax years 2004/05 and 2005/06 or for accounting periods ended on dates between 19 March 2004 and 29 June 2006 (inclusive), provided that those claims are for additional foreign tax credit relief resulting from the change of practice and are made no later than 30 June 2010.

Contributed by Robert Jamieson

Lecture P604 (9.40 Minutes)

Agricultural property relief and the Atkinson case

The First-Tier Tribunal has recently delivered judgment in the case of *Atkinson v HMRC (2010)* relating to the meaning of agricultural property for IHT purposes. One of the partners in a farming partnership lived in a bungalow on the farm until ill health required him to move into a care home. His possessions remained there and he made occasional visits to the bungalow.

After the partner died in 2006, HMRC contended that the bungalow was not occupied, throughout the seven-year period ending with the death, by him or another for the purposes of agriculture (see S117(b) IHTA 1984). They argued that the partner could not realistically be said to be in occupation nor could it be said that the property was being used for agriculture. In the circumstances, this seems a reasonably convincing point of view.

However, the Tribunal stated that the deceased had been a partner in the farming business until he died. The bungalow had been used to accommodate the diminishing needs of one of the partners. Accordingly, they concluded that it was qualifying agricultural property and so relief was available.

Contrast this case with the earlier decision in *Harrold v CIR (1996)* where a substantial farmhouse, which had not been lived in for several years, was purchased by a partnership consisting of a father and his son prior to being the subject of extensive renovations and building works. The arrangement was for the son to occupy the farmhouse, but the improvements were not completed by the time of the father’s death and the son had not moved in. It could not therefore be said to have been occupied for the purposes of agriculture.

Contributed by Robert Jamieson

Lecture P605 (7.18 Minutes)

Administration

Company Tax Returns - Changes to the paper returns HMRC sends out

From 1 April 2011 onwards, all companies and organisations must submit their Company Tax Returns online for any accounting period ending after 31 March 2010. You can use HM Revenue & Customs (HMRC) free software, commercially available software, or the services of a tax agent or adviser to file your return for you.

In preparation for the change from paper to online, HMRC will not be issuing blank paper return forms and guidance notes (forms CT600 & CT600 Guide) with the "Notice to deliver a Company Tax Return" (form CT603) from 1 July 2010. HMRC currently provide paper forms to those companies and organisations who don't have a tax agent or advisor or those who don't use approved substitute return forms.

You'll still be able to download and print the forms from the HMRC website after 1 July 2010 but you'll have to submit your return before **1 April 2011** if you want to use paper for any accounting period ending after 31 March 2010

Corporation Tax agents: getting an agent code and changing your details

All tax agents and advisers who want to act on behalf of companies and organisations that are liable for Corporation Tax require a national agent code. Agent code requests and written requests to change Corporation Tax agent details are now dealt with by a centralised team based in Longbenton.

Agent codes

You must have an agent code for Corporation Tax before you can set up client authorisations using HM Revenue & Customs (HMRC) online agent authorisation process or paper form 64-8.

To request an agent code from HMRC you need to supply your:

- name
- business name
- business address - for example your firm's address
- business telephone number

All Corporation Tax agent code requests must be made **in writing** and sent to:

HM Revenue & Customs
Central Agent Authorisation Team
Agent Maintainer
Benton Park View
Longbenton
Newcastle upon Tyne
NE98 1ZZ

New agent codes will be sent to you by letter. Once you have a code, it should be used in all online agent authorisations and on paper 64-8 forms.

The Central Agent Authorisation Team is responsible for creating Corporation Tax agent records and keeping them up to date. Centralising this process will help HMRC provide a more efficient, effective and consistent customer service.

Updating your agent details

You need to tell HMRC about any changes to your:

- contact name
- business name - for example ABC accountants changing to 123 Accountants
- business address
- business telephone number
- trading status as an agent - for example if your business ceases

You'll also need to tell HMRC if your firm merges or takes over another agent's business. You can make some changes to your communication details online – for example your email address - but other changes must be made **in writing** and sent to HMRC at the above address.

There may be exceptional circumstances when your need to discuss issues around this process. HMRC are looking at the best way to do this and will provide an update in the near future.

Get form 64-8 (PDF 155K) (http://www.hmrc.gov.uk/forms/64-8.pdf)

Log on to Corporation Tax Online (https://online.hmrc.gov.uk/login)

Overpayment relief and practice generally prevailing

Introduction

The purpose of this Revenue and Customs brief is to:

- Publicise the introduction of overpayment relief from 1 April 2010.
- Advise how HMRC consider practice generally prevailing affects overpayment relief and error or mistake relief claims following the judgment of the Court of Appeal in the Franked Investment Income Group Litigation.

Overpayment relief

It is no longer possible to claim error or mistake relief for income tax, capital gains tax and corporation tax. From 1 April 2010, it has been replaced by overpayment relief. Guidance on the new relief can be found at SACM 12000 onwards.

Other formal or informal processes for reclaiming overpayments have not changed.

Time limits

Claims must be made within 4 years of the end of the tax year or accounting period to which the claim relates.

This time limit does not apply where the claim relates to a mistake in an individual's 2004-05 or 2005-06 self-assessment return if they were not given a notice to make the return within 12 months of the end of the tax year. The time limits for claims in these cases are 31 January 2011 and 31 January 2012 respectively.

Form of overpayment relief claims

Claims must be made in writing and:

- State that the person is making a claim for overpayment relief under Schedule 1AB TMA 1970 (Paragraph 51 Schedule 18 Finance Act 1998 for corporation tax claims).
- Identify the tax year/accounting period for which the overpayment or excessive assessment has been made.
- State the grounds on which the person considers that the overpayment or excessive assessment has occurred.
- State whether the person has previously made an appeal in connection with the payment or the assessment.

– If the claim is for repayment of tax, include documentary proof of the tax deducted or the tax being suffered in some other way.

– Include a declaration signed by the claimant stating that the particulars given in the claim are correct and complete to the best of their knowledge and belief.

Claims cannot be made in self-assessment returns and will not be accepted if they are made on an SA return form (SA100) or equivalent, such as the Trust and Estate Tax Return SA900 or company tax return (CT600).

Practice generally prevailing

Both error or mistake relief and overpayment relief have an exception where the tax was calculated in accordance with prevailing practice at the time.

HMRC have considered the comments of the Court of Appeal concerning prevailing practice in the Franked Investment Income Group Litigation (Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners [2010] All ER (D) 261 (Feb), paras 255 to 264).

In the view of the court, the practice generally prevailing exception is to be read as subject to the limitation “that it applies only if and to the extent that the United Kingdom can consistently with its [EU] treaty obligations impose such a restriction”. The court concluded that practice generally prevailing does not affect a claim for repayment of taxes paid in breach of EU law.

HMRC understand this principle also applies to the new overpayment relief. Therefore, if a claim for error or mistake relief or overpayment relief relates to taxes paid in breach of EU law, HMRC will not seek to disallow it on the basis that the tax liability was calculated in accordance with the prevailing practice.

The other conditions for error or mistake relief and overpayment relief, such as time limits, will still need to be met in all cases.

HMRC Brief 22/2010 4 June 2010

Automatic penalties for late company and employers' / contractors' end-of-year returns

This brief announces that Extra Statutory Concession B46 will come to an end on 31 March 2011; customers submitting company tax returns and employers' end-of-year returns after this date must make sure the returns are submitted by the required dates.

Purpose of this brief

This Revenue & Customs brief announces that ESC B46 will come to an end on 31 March 2011. Customers submitting Company Tax returns and employers' end-of-year returns after this date must make sure the returns are submitted to us by the required dates.

Readership:

All those required to file Company Tax returns, and Pay As You Earn (PAYE) end-of-year returns (forms P35 and P14).

Background:

ESC B46 was introduced in 1995. Under this concession, we will not issue penalties for late filing of Company Tax returns or employers' and contractors' (Construction Industry Scheme) end-of-year returns, provided they are received by the last working day within seven days of the filing date. The ESC ensured that penalties would not be charged when customers had taken all reasonable steps to file the returns on time, but were prevented from doing so, for example due to postal delays.

Online filing

From 1 April 2011, Company Tax returns for accounting periods ending after 31 March 2010 must be filed online. All forms P35 and P14 must already be filed online, and we will no longer accept paper returns from the majority of customers. Contractors are no longer required to file

end-of-year Construction Industry Scheme returns. ESC B46 has therefore become redundant because the possible causes of late filing it was intended to address can no longer arise.

Therefore, ESC B46 will come to an end on 31 March 2011. Customers submitting Company Tax returns and employers' end-of-year returns after this date must make sure the returns are submitted to us by the required dates.

Any customers filing a return late will, as now, be able to request us to remove any penalty, if they believe they had a reasonable excuse for the delay in filing. We will consider every case on its own merits. Customers can also appeal against the penalty to a Tribunal.

HMRC Brief 24/2010 3 June 2010

Access to private bank accounts

What's the problem?

Ever since the self assessment enquiry regime came into being, it has been a moot point whether or not HMRC can demand access to private bank accounts. The new information powers at FA 2008, Sch 36 have not really clarified this issue. Schedule 36 gives HMRC an unappealable right to demand 'statutory records'.

Statutory records

Statutory records are the documents and information which a person is required to keep and preserve to fulfil their obligations under the Taxes Acts and VAT legislation.

The new information powers contain no more detailed requirements, so we have to go back to TMA 1970, s 12B to see what this might mean to an individual.

Taxpayers must retain records which substantiate the entries on the return. Broadly, a business taxpayer is required to maintain records of:

- receipts and expenses;
- sales and purchases;
- other supporting documents.

for five years after the fixed filing date.

Note that a business taxpayer's return may also include private bank accounts, etc. The legislation talks of 'records kept by a business taxpayer', not 'business records'. Therefore, private bank details would be caught by this five-year rule.

Non-business taxpayers have to retain records to substantiate entries on the return for one year from the fixed filing date. So, in respect of a purely private bank account, the only entry on the return which would have to be substantiated is the interest figure. Interestingly, purely private bank statements are clearly not statutory records and so the taxpayer is not obliged to keep them at all.

What was the guidance?

Compliance Handbook CH223430 has disapeared but used to say:

> 'The over-riding test is based on what is reasonable (that is, fair and sensible) in the circumstances.The question of whether it is reasonable to request private documents including bank and building society accounts can only be determined by reference to the facts in each individual case.
>
> 'Non-business bank details should not be requested in the opening letter as a matter of course. However, where accounts are not based on a robust and effectively operated record keeping system which is supported by adequate and appropriate safeguards and/or include unvouched or unverified sums, it would be reasonable to request the private bank details with the other records. The position could be established through telephone contact with the agent or by making the basis of the request clear in the opening letter.'

The manual went on to cite some examples where inspectors might want to see private bank records:

- they think that undeclared income or gains have been credited to the private account;

- they have doubts or questions about means or capital growth;
- they think that the tax return was based, wholly or partly, on the 'private' bank account documents;
- where taxable receipts or expenditure are unvouched or estimated and it is reasonable to expect that this expenditure should have been vouched/recorded; or
- where payments from an account to the business are treated as non-taxable, for example capital introduced (where not independently verified).

The manual then states that when determining whether to require non-business information you should consider

- 'costs (in time and money),;
- 'rights of privacy

Practical implications

It is worth bearing in mind how HMRC should operate an enquiry, particularly into a business. They are supposed to make a case, on the balance of probabilities, that the business records are 'materially inaccurate' (my terminology). To use an HMRC phrase, the records have to be 'broken'.

Once that has been done, HMRC are then at liberty to try to quantify the omissions. If the omissions are extractive, this could entail a business economics exercise, a means test or a capital statement.

All of these are meaningless, however, unless the records have been broken in the first place.

What is clearly unacceptable is to demand the private bank accounts at the outset of an enquiry, demand explanations of every private transaction and state that, if each private transaction cannot be explained, those deposits will be taxable.

Yet this is exactly the approach I have seen regularly in the last few months.

The HMRC guidance clearly makes the following points:

- requests have to be reasonable (fair, sensible, proportionate, not excessive, suitable, logical);
- the records have to be broken;
- non-business bank details should not be requested in the opening letter as a matter of course;
- costs: copies of private accounts should only be demanded if the cost to the taxpayer is proportionate to the risk; and
- Article 8 of the Human Rights Act gives individuals a fundamental right to privacy in their private affairs unless they have been fiddling their tax, but HMRC have to make a case that the taxpayer has been fiddling.

The real world

It is interesting currently that there are so few enquiries about. However, those in existence seem almost to be following a pro forma approach: 90% of the requests are standard and every 'new style' enquiry that I have come across requests private bank accounts in the opening letter, clearly contradicting the missing guidance in CH223430.

In the most recent case that I have seen, HMRC requested all the business records, etc., but wanted an initial meeting with the taxpayer to discuss the way the business operated and also the private affairs of the proprietor.

At the meeting, HMRC focused purely on the private affairs, 'interrogated' the taxpayer and demanded the private accounts.

Three months down the line, the taxpayer has received an information notice demanding verification of numerous private transactions, copy statements, credit card statements and mortgage application form. HMRC have not even looked at the business records yet.

Where does this leave us?

The guidance in CH223430 has currently been replaced with nothing. It is not clear why it has disappeared but the principles contained in it are not new and, even without guidance, the moral is clear: no access to private bank accounts unless HMRC prove, on balance, there's a fiddle.

From an article by Mark Morton writing in Taxation

Business Tax

Wholly and exclusive health costs

In the recent case of *Mr David S Parsons* (TC421), Mr Parsons was a self employed stunt performer and double in film and television productions who, for the years ended 5 April 2003, 2004, 2005 and 2006, claimed s74 deductions for:

- 'medical expenses'
- 'health & fitness'
- 'chiropractor/massage'
- 'dentist'

Wholly and exclusively

The case of *Mallalieu v Drummond* [1983] STC 665 was considered. For the expenditure to be deductible, the main reason for the expenditure had to be wholly and exclusively for the purposes of the business and the onus of proof was on the taxpayer; provided that any other benefit was purely incidental to the carrying on of the trade that was OK.

The Tribunal determined that medical expenses therefore will normally serve a dual purpose and will not satisfy the "exclusivity" test. However, where medical expenses can be said to be of "a special character dictated by the occupation as a matter of physical necessity", the Tribunal considers that it may be possible to conclude that the expenses were "wholly and exclusively laid out or expended for the purposes of the trade or profession", and that any benefit as a human being is merely an "unavoidable effect" rather than a purpose of the expenditure'.

Medical expenses

In this case, as an ordinary human being he could have – and would have been content to have – waited for an operation on the NHS and if the job had been less physically demanding he could have carried on working in the meantime. It was only the particular demands of the job that necessitated the expense of the private operation. The benefit to him as an ordinary human being was therefore an 'unavoidable effect'.

Chiropractor, masseur and dental expenses

The Tribunal held that the same reasoning applied to the expenditure on chiropractor, masseur and dental expenses and agreed that these were also tax deductible.

Health and fitness

However, the costs of the less specific fitness training and boxing classes were held to be a more general requirement and true of many occupations – comparable to having to maintain a certain level of appearance – and were not allowed because they were not incurred 'exclusively'.

Was the Tribunal right?

Were these costs were actually incurred 'for the purposes of the trade or profession' or did they simply put the taxpayer into a position to carry on the trade or profession.

There is an argument that the chiropractor and masseur costs are incurred in keeping the stunt performer in condition during a performance and might therefore be of a 'special character'.

However, while laid up with a broken leg surely the trade or profession cannot actually be carried on. My question would then be whether the expense was actually 'wholly and exclusively laid out or expended for the purposes of the trade or profession' or whether it simply put the taxpayer in a position to carry on his trade or profession?

A special need

What about Maslow's hierarchy of needs? Surely a set of functioning limbs are part of the basic physiological requirements that underpin all human need – not far above breathing, food and water, and surely before Ms Mallalieu's clothing in the heirarchy?

Whatever the requirement of the occupation, of all types of expenditure, surely that of maintaining basic human functions must serve 'an inevitable need as a human being'.

Both HMRC and the Tribunal say that such cases are dependent on their particular facts.

The brickie

Consider Mr Hod, a self-employed bricklayer – working in an industry that accounts for 30% of all work-related fatalities each year.

He drops a brick on his foot and is unable to walk. He eventually sees a specialist who tells him that ligament damage means that he will need an operation and physiotherapy to enable him to walk again and carry on bricklaying.

He could wait a year and have this done on the NHS, but instead pays to go for private treatment; this enables him to return to work in a matter of a month or two rather than a year or two.

Mr Hod's business involves more than enough physical activity to keep him fit and when not working he prefers to watch television or play video games. As far as he is concerned, the only reason to pay for the operation is to continue his business, show that he is a reliable worker, and keep future contracts coming in.

Are the medical costs allowable here? Does the injury and operation in such a case have any more or less of a 'special characteristic' than for Mr Parsons?

The journalist

What if a self-employed journalist has spent so much time in front of a computer screen that his eyesight has got so poor that he needs to wear glasses to prevent splitting headaches which would prevent him from working? Are the costs of glasses and check-ups tax deductible?

He doesn't need glasses for longer distance viewing such as watching TV, driving, or going to the cinema or theatre. However, perhaps he answers personal e-mails at home and wears the glasses then. Is this an unavoidable effect? And what if he decided to pay for laser sight-correcting surgery, would this be allowable?

The doctor

A self-employed doctor is presumably more likely to contract some disease from a patient. Does this mean he can also claim medical costs incurred in his recovery?

Conclusion

Now that Mr Parsons has got his foot, or more properly his knee, in the door of allowable expenditure, will more tax practitioners be making claims along these lines?

Strangely, although the expenses for 'health and fitness' were disallowed by the tribunal in the *Parsons* case as not being of a 'special character', I understand – as noted in the Feedback item Gym membership (see June update) – that HMRC agree that divers can claim a proportion of their gym expenses and dental expenses. I wonder if the Tribunal was aware of this.

Taken from an article by Richard Curtis

Lecture B601 (10.14 Minutes)

Income shifting

From 6 April 2010 the personal allowance will be reduced by £1 for every £2 of income in excess of £100,000 thus creating a marginal tax rate of 60% for income between £100,000 and £112,950. In addition, a new higher rate of income tax of 50% will be applied to those earning in excess of £150,000. The higher rate of tax on dividends in excess of £150,000 is 42.5% (translating to 36.11% of the net dividend).

With increasing higher rates of personal tax in 2010/11 a greater emphasis might well be placed on diverting income to spouses and civil partners.

In the case of a close company this diversion of income is obtained by ensuring that the non-working spouse owns some of the ordinary shares. Diverting income to the non-working spouse has been widespread for many years – particularly after HMRC's loss in the infamous *Jones v Garnett* case. Given the increase in tax rates in 2010/11 further share transfers are likely to be common place.

Example

Theo runs a management consultancy company which makes annual post tax profits of £200,000. Theo's wife Georgina works in the business part time and is paid a personal allowance salary. Theo also has a personal allowance salary, a company car and private healthcare for the family. Historically the company has paid all the post tax profits out as dividends.

Theo owns 80% of the shares whilst Georgina owns the remaining 20%. Georgina's shareholding has been sufficient to utilise her basic rate band in previous years but the situation has changed in 2010/11. Theo's earnings are in excess of £150,000 and as such he will pay the higher dividend rate of 36.11% on dividends breaching the £150,000 mark. This is a 45% increase in tax rates on the dividends exceeding £150,000 (25% v 36.11%).

If Theo were to transfer a further 15% of his shares to his wife he will avoid the 36.11% tax rate – a saving of approximately £3,500 in tax in 2010/11.

Safe advice?

Whilst HMRC lost *Jones v Garnett* it should be noted that the settlements legislation still exists and we must be careful to ensure that the original holding (20% above) and the any further transfers (15% above) are not caught by the settlements legislation.

Further transfers might also be considered where one spouse is in the 60% band.

The settlements legislation

The legislation relates to informal settlements and is currently contained in *ITTOIA* 2005, Chapter 5, Part 5, and we shall be looking in particular at the scope and operation of *ITTOIA* 2005, s. 619-626, which are the re-written forms of our old friends *ICTA* 1988, s. 660A-660G.

An unforeseen consequence of *Jones v Garnett* is a popular assumption that in some way the settlements legislation has been emasculated. That is very much not the case: although it may not have struck home in *Jones v Garnett*, the force of the legislation remains great and is a significant obstacle for advisers to overcome.

Broadly, if a person genuinely gives away income or income-producing assets, then Parliament is happy not to tax the income on the donor because he really has not got the income; but if the donor is going to enjoy the income in some way, then Parliament is no longer happy to collaborate in the pretence, and levies tax as if nothing had happened.

How does the settlements legislation work?

There are two strands to the effective targeting of the provisions. The first is at s.624(1), which sets out the basic rule that income is treated as that of the settlor:

'… if it arises … from property in which the settlor has an interest'.

The enormous breadth of the circumstances in which the settlor might have such an interest is then defined in s. 625(1), so that such an interest will arise:

'… if there are any circumstances in which the property or any related property is payable to the settlor or the settlor's spouse or civil partner, is applicable for the benefit of the settler or the settlor's spouse or civil partner, or will, or may, become so payable or applicable'.

It is important to note that the concept extends far beyond a tight focus on the payment or application of the property transferred and embraces 'related property', which means:

'… income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it'.

Save for the useful point that the definition looks only to the future and not to the past, it is hard to think of anything broader.

It is similarly important to note that the statutory focus of s. 625(1) is not just on the payment or use of money as such. It includes circumstances where the money is or may be applicable for the benefit of the settlor. The statutory opposition of 'payable to' and 'applicable for' indicates that what is envisaged is the provision of non-cash benefits funded out of the property or related property. The statute asks the question whether the settlor has benefited because the money has been applied in a certain way without it being paid to the settlor. It then contemplates the possibility of payment or availability in the future, so deferral arrangements are rendered inoperative. A moment's reflection shows not only how broadly the concept of a retained interest is, but also the enormous forensic exercise involved in ascertaining that the settler has not benefited, and will not benefit, from the application of the funds. However, Parliament has seen fit to exclude certain settlements from the scope of the settlements legislation.

Spouse exemption

The most important of those exclusions, and the one whose protection most intra-family income planning seeks to enjoy, is the so-called 'spouse exemption' at s. 626. It is the spouse exemption that, following *Jones v Garnett*, many advisers see as a 'get-out of- jail-free' card. Is that view justified?

On some matters, yes. The concept of property being wholly or mainly a right to income is now far better understood, which is helpful. Lord Hoffman held, at paragraph 28 of his judgment, that the scope of s. 626 was wider than that of mere property transfers and was capable of embracing circumstances such as those in *Jones v Garnett* where no property was actually transferred between the spouses, with the practical effect that 'property' in s. 626(1)(a) can include an arrangement where the arrangement itself constitutes a settlement. That may prove to be a useful (albeit non-statutory) extension, allowing one to argue that, for example, a dividend waiver might be within the scope of s. 626.

However, on the question of whether an inter-spouse transfer is an 'outright gift', there is still much cause for concern. The phrase 'outright gift' is not an expressly defined term, but it is limited to exclude certain transactions from the protection of s. 626. In particular, under subsection 4:

'A gift is not an outright gift … if

a) it is subject to conditions, or

b) there are any circumstances in which the property, or any related property,

(i) is payable to the giver,

(ii) is applicable for the benefit of the giver, or

(iii) will, or may become, so payable or applicable.'

The language used in (b) is the very broad language used to identify retained benefits in s. 625(1). However, it is also entirely consistent with the policy reason behind the enactment of s. 626, which was to respect the independent taxation of husband and wife. Thus s. 624(1), which deemed a spouse's income to be that of the settlor spouse if it arose under a settlement, was disapplied where the income became that of the beneficiary spouse – but only where the alienation of the funds was genuinely reflected in its payment and application. Thus spouses were put on to exactly the same footing as third parties – the settlor was not taxed unless a benefit was retained. There is policy consistency across the board.

Judicial opinion in *Jones v Garnett* and in all other cases wherein s. 626 and its predecessor *ICTA* 1988, s. 660A(6) have been considered have dealt only with the question of whether the gift was conditional. There has never been any consideration of the scope of the second (and equally important) half of the definition, which looks at the payment and the application of the funds.

Applicable for the benefit of the giver

Interestingly, although the dividends in *Jones v Garnett* were paid into a joint bank account, no evidence was put before the Special Commissioners as to whether the property or any derived property (now 'related property' in s. 626) were applied for the benefit of Mr Jones. It followed that there was no judicial comment. Had such evidence been put forward, the result may have been very different.

The point remains open. In most modern marriages, and *a fortiori* in cases where there is a single or principal earner and that spouse's income is diverted to the other, there will be a rebuttable presumption that all the money is required for the purposes of the family's well-being. So if, for example, a joint mortgage interest liability is paid by one spouse using money arising under a settlement, or if a family holiday or a family car or an anniversary meal out is funded in the same way, or school fees are paid where both parents are liable to pay, then property, or related property, will be being applied for the benefit of the settlor spouse and the gift falls outside the protection that s. 626 provides.

That may seem harsh, or to be descending to trivial and intrusive levels of detail: but the words 'applicable for the benefit of the giver or will, or may become, so … applicable' are not defined, and their natural and unforced meaning is easily wide enough to encompass those examples and more.

Further, taking a purposive approach to the statutory language gives the same answer. The purpose of the settlements legislation is to attack those who seek the tax advantages of giving income away while still enjoying the benefit of it – and s.626 justly applies that principle to independent taxation.

Type of transfer caught

Remember too that this is not something that is limited to share transfers. It can apply also to transfers of any property, such as interests in rented land and buildings. The rent arising will be within s. 624(1) unless the settler does not benefit in any way as a result of the income paid to the other spouse.

When the narrow scope of the term 'outright gift' is appreciated, it becomes apparent how difficult it is to structure a client's affairs to escape s. 624 in relation to inter-spouse transfers. Only where property and related property is wholly segregated from the settlor spouse can the protection of s. 626 be gained. That is a question of fact, and taxpayers would be well advised to be rigorous in retaining evidence of the application of funds. Married taxpayers will have to exercise continuous iron discipline not only over their financial affairs, but over their behaviour, if they are to satisfy the exacting requirements of s. 626. In practice few taxpayers will be able to maintain those standards.

That is particularly important to acknowledge now, when HMRC will be on the alert for attempts to avoid the new higher rates of tax. The settlements legislation is a self-assessment obligation, and so it is not good enough to wait for HMRC to take the point and argue it. Particularly where the statutory language is so clear, those failing to recognise that the settlements legislation applies to them may well find HMRC taking the view that their return contains a deliberate inaccuracy. The consequences could be severe.

Summarised from an article by Andrew Gotch, Tax Adviser February 2010

Lecture B602 (19.47 Minutes)

The decision in Novasoft Ltd

In a recent employment status case, the First-tier Tax Tribunal determined that the affairs of *Novasoft Ltd* (TC456) did not come within the intermediaries legislation in FA 2000, s 60 and Sch 12, known as IR35, during the years under review.

Background

Mr Novak Brajkovic is an information technology (IT) analyst and programmer. In February 1997, the company Novasoft was incorporated, and was owned 75% by Mr Brajkovicas, sole director, and 25% by his wife.

In July 1998, Novasoft entered into a 'lower contract' with Lorien Holdings Ltd, and this contract was extended on several occasions up to December 2002. The business of Lorien was to act as an agency providing IT contractors to companies engaged in IT projects.

Lorien entered into an 'upper contract' with Zeneca Ltd and, in July 1998, Mr Brajkovic began working for Zeneca Specialities. He worked on three IT projects being undertaken by Avecia.

In June 1999, Avecia was spun out of Zeneca, and for the purposes of the IR35 legislation the 'client' was Avecia.

It should be noted that the first 21 months of the contract pre-dated the IR35 legislation, which was introduced on 6 April 2000. HMRC had accepted, for that period, that the arrangements were a contract for services performed by Novasoft for Avecia.

When IR35 came into effect, Nick Brajkovic, who was company secretary of Novasoft and a practising accountant, considered that Novasoft was not caught by the new regime, but suggested that the contracts should be submitted to HMRC, this being the procedure recommended by the professions during the early days of IR35.

This decision backfired, as there ensued two years of correspondence between HMRC and Novak Brajkovic, with the Revenue asserting that Novasoft was caught by the IR35 provisions. In late 2005, the company received determinations from HMRC demanding just under £50,000 in income tax and National Insurance contributions.

Mr brajkovic took his case to appeal personally which meant that he made submissions on behalf of Novasoft as advocate and not as a witness, and denied HMRC the opportunity to cross-examine him.

Notional contract of employment

The approach to be taken by the First-tier Tribunal was to hypothesise a notional contract between the worker (Mr Brajkovic) and the client (Avecia) and then to consider whether, under that notional contract, the worker would have been an employee of the client.

That should be done under the normal principles of contract and employment law, irrespective of IR35.

Both parties endorsed the very substantial body of case law on whether or not a notional contract of employment existed, in particular *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497, *Market Investigations Ltd v Minister of Social Security* [1969] 2 QB 173 and *Hall v Lorimer* [1994] STC 23.

Control

The notional contract would have required Mr Brajkovic to undertake his work in accordance with standards and protocols necessary to make the project work-product fit for purpose and maintainable in the future by other IT experts, also to commit sufficient time to that work in order for deadlines and budgets to be met, and to ensure any significant absences fitted with the staffing of the project overall.

Otherwise, the notional contract would not have been prescriptive as to exact hours of attendance, or the exact manner in which Mr Brajkovic implemented the skilled tasks assigned to him.

In actual fact, Mr Brajkovic usually took between eight and 12 weeks' holiday each year.

Substitution

The notional contract would not have permitted substitution by another IT worker.

Mutuality of obligation

The notional contract between Avecia and Mr Brajkovic would have established mutuality of obligations during the term of the contract but, for the reason put forward by Mr Justice Park in *Usetech v Young* [2004] STC 1671, the tribunal considered that it is appropriate to a self-employment contract as well as one of employment.

Financial risk of the worker

The notional contract between Avecia and Mr Brajkovic would have given Mr Brajkovic a risk of non-payment by Avecia. However, the tribunal did not see that as a helpful distinction between a contract of service and one for services in the circumstances of this notional contract.

Provision of equipment

The notional contract would not have required Mr Brajkovic to provide any IT equipment or software of his own and, indeed, may have required him to use only that provided by Avecia because of security concerns.

Basis of payment

The notional contract would have provided for an hourly rate of compensation, and would have required proper invoices to be delivered periodically.

Employee rights

The contract would not have provided any typical employee benefits or statutory protections.

Termination of the contract

It was concluded that the notional contract between Avecia and Mr Brajkovic could have been terminated by either party on a reasonable stated period or immediately in the event of breach.

Part and parcel of the organisation

Mr Brajkovic listed seven points regarding the differences between Avecia employees and independent IT contractors, to illustrate that he was not ‘part and parcel’ of the operation.

Exclusive services

The contract would not have prevented Mr Brajkovic from undertaking other assignments that did not conflict with Avecia’s business interests, provided he gave priority to his work for Avecia.

Interesting outcome

The tribunal considered that the overall picture was one of a contract of self-employment. Substitution could have been an important factor, but its absence did not disturb the overall impression that the tribunal had formed of the notional contract.

This was a fascinating case for a number of reasons. Specialists in status cases would expect a successful appeal to demonstrate lack of control, the facility of substitution and lack of mutual obligation. None of these three factors were definitely proved in *Novasoft*.

The employment status indicator, so favoured by HMRC, is likely to have shown Mr Brajkovic to be an employee.

The *Novasoft* decision gives hope to individuals who truly believe that they are self-employed and are prepared to go the distance to prove that fact.

Taken from an article by John Newth

Lecture B603 (13.07 Minutes)

Smith v Revenue and Customs Comrs

Between 1998 to 2002 the appellant, who worked as a contractor in the construction industry, used T as his accountant to prepare his annual accounts and tax returns. Prior to that, he had used another firm of accountants.

For the years 1999 and 2002 (but not 2000) the figure for stock and work in progress included in the accounts was an estimate. In the 2000 accounts the stock and work in progress figure represented work in progress in respect of one contract only and represented the realisable value of work done under that contract before the year-end determined by reference to post balance sheet events.

Following an enquiry into the appellant's tax return for 2001, HMRC formed the view that the taxable profits of his business were misstated for a number of years. HMRC issued discovery assessments under TMA 1970 s 29 for the tax years 2002 and 2000 and under ss 29 and 36 in respect of the years 1994, 1995, 1996, 1998, 1999, alleging that the accountants' actions constituted negligent conduct. The appellant appealed.

The following issues arose for consideration:

(i) the correct computation of the profits of the appellant's trade. In respect of the years 1998 to 2002, FA 1998 s 42(1) provided that the profits "must be computed on an accounting basis which gives a true and fair view". Subsection (3) applied to periods of account beginning after 6 April 1999 and so s 42 applied to the computation of the appellant's profits in respect of the years ending 5 April 2001 onwards. After 2002 s 42 was amended to require computation in accordance with "generally accepted accounting practice". Before FA 1998 the case law made it clear that profits and losses of a business for tax purposes were those determined on "the correct principles of the prevailing system of commercial accounting";

(ii) the standard against which conduct had to be judged. The appellant argued that the standard was that of the reasonable man, not that of the reasonable chartered accountant. Negligence in that context was not adopting an accounting practice on which opinions might differ, but making an obvious and significant arithmetical error in the accounts or adopting an accounting policy wholly outside the realm of commercially acceptable accounting practice; and

(iii) the applicable accounting standards. SSAP 12 was in force from 1972 until it was withdrawn and replaced by FRS 18 from June 2001. To some extent it was superseded by FRS 5 from 22 September 1994. Accounts had to be prepared on an accruals basis (ie revenue and costs were recognised as they were earned or incurred not as money was received or paid). The implications of the accruals concept was that the profit and loss account reflected changes in the amount of net assets which arose out of transactions in the period. So revenue and profits were matched with costs incurred in earning them.

The prudence concept also applied which meant that

(i) revenue and profits were not anticipated but were recognised by inclusion only when realised in the form either of cash or of other assets the cash realisation of which could be assessed with reasonable certainty; and

(ii) provision was made for all known liabilities.

Under FRS 5 if the accounts had been prepared on a basis which differed from that, they required a clear statement to that effect.

In December 2003 an application note—application note G ("AN G")—was added to FRS 5 dealing with the recognition of revenue from the supply of goods and service. SSAP 9—stocks and long-term contracts—applied to accounting periods beginning after 1 July 1998 and included work in progress. It provided that attributable profit should be recognised in the value of work in progress on such contracts. SSAP 17 applied from 1 September 1990.

It dealt with events which occurred after the balance sheet date and before accounts were signed. FRS 18 was published in December 2000 and took effect for accounting periods ending after 2001. The appellant argued that until the publication of FRS 5, AN G there was a choice available in setting accounting policies in relation to those matters.

T gave evidence that the only reliable accounting basis across the construction industry was to recognise income on the basis of the customer's valuation certificates. That practice was commonly used in the construction industry and was applied consistently from year to year in preparing the appellant's accounts. The use of applications for payment would be a dangerous method to follow as the eventual payments might not follow the applications. In relation to work in progress, T said in his witness statement: "I have in general not included work in progress in the accounts. That is because it would have been incorrect to take out expenses which had actually been incurred."

The tribunal considered that there would be little or no difference between profits ascertained in accordance with FA 1998 standard and that previously applicable as accounts would not show a true and fair view unless they were prepared on the principles of the prevailing commercial accountancy. In relation to periods before the application of FA 1998, the tribunal found that it was generally accepted accounting practice to follow applicable published accounting standards unless there were exceptional circumstances justifying departure therefrom. After 1994 accounts which were to show a true and fair view had to be prepared, save in exceptional circumstances, upon the accruals basis and that basis required the recognition of assets (as access to future economic benefits controlled by the entity) where there was sufficient evidence of the existence of those assets and they could be measured as monetary amounts with sufficient reliability.

The tribunal considered that a person who acted for another person as an accountant and tax adviser should reasonably be expected to show the normal competence associated with the proper discharge of the duties of an accountant and tax adviser. The failure to do what an ordinarily competent adviser would do was failure to do what ought to be done. The failure to do those things which a reasonable man guided by the considerations which would ordinarily be expected to arise from such a relationship was a failure to take proper or reasonable care. That was not the same as saying that because a person was a qualified accountant he was to be expected to display by virtue of his training and qualification a greater standard of care; it was saying that because of the role he occupied he should reasonably be expected to display the kind of care which a person in that role would ordinarily display. Therefore where a professional firm was formally engaged then unless there were special circumstances the reasonable man would have taken care to submit accounts prepared under generally accepted accounting practice ("GAAP") which showed a true and fair view. If they contained a significant arithmetical error or if they were prepared on the basis of accounting policies or practice which were outside the realm of commercially accepted accounting practice then they would not show a true and fair view. If they were prepared on the basis of an unusual accounting practice but were within the realm of what was generally accepted, they would show a true and fair view.

The tribunal considered that in determining the applicable accounting standard, the issue in each case was whether the accounts were prepared consistently with the policies adopted by other entities in the same industry, unless there were circumstances justifying departure. The accounting standards contained no indication that a particular accounting policy or practice was applicable merely because of the business sector of an enterprise. They were concerned instead with the particular position of a particular enterprise. If the appellant's business was different from other businesses then it might need different accounting policies. There was no requirement that accounting policies be consistent across any particular sector. Instead what was required was the consistent application of the principles and standards to the particular circumstances of a particular business. On the facts, by failing to include work in progress and stock in the accounts, T had ignored the provisions of SSAP 9. He had also failed to comply with FRS 5, and also SSAP 17. The inaccuracies in T's recognition and rendition of accounting standards indicated that his view of proper accounting policy was not one which could be relied upon as being in accordance with the principles recognised by accounting standards. As a result the accounts prepared for 1998 to 2002 did not comply with accounting standards. In relation to the years 1994–97 the appellant had used different accountants and there was no information on the accounting practice adopted by them. No discovery of an under assessment was made in those years. In relation to each of the years 1998–2002 there was negligent conduct on the part of the person acting on the appellant's behalf to which was attributable the under assessment of income in the years 1998 to 2000 and 2002. Thus the condition in TMA 1970 s 29(4) was satisfied. It followed that the appeals in relation to 1995–97 would be allowed and the appeals in relation to 1998 to 2002 would be dismissed.

Appeal allowed in part.

Tribunal: Charles Hellier (Chairman) and John Cherry, 24 February 2010

Unfettered substitution

Talentcore Ltd provided staff, referred to as consultants, to work for cosmetic companies at duty free shops at airports.

HMRC issued assessments to tax under PAYE and National Insurance for the years 1998/99 to 2006/07 on the basis that the consultants were agency workers providing personal services and therefore subject to PAYE under ITEPA 2003, s 44 to s 47.

The company appealed.

The tribunal found, after hearing the evidence, that there was no framework contract between the company and the consultants, so the former was free to offer work to the consultants or not, and the consultants were free to accept or decline the work.

Neither was there a written contract between the company and the cosmetics companies or the consultants.

No training was provided by the company, although consultants are given guidelines regarding dress and conduct. Importantly, consultants who were unable to work for an agreed slot were expected to inform the company and find a replacement.

The judge said that given the temporary and ad hoc nature of the company's bookings, the right of substitution which the consultants had prevented there being a contract of service. It also prevented the obligation to provide personal services within the legislation.

The company's appeal was allowed.

This is an interesting decision reflecting the importance of the right of substitution, and the degree of control when considering whether a contract of service exists.

The result is in direct contrast to the recent *Weight Watchers* decision, in which the meetings' leaders were found to be employees.

http://www.taxation.co.uk/taxation/articles/2010/06/11/20535/unfettered-substitution

Goodwill valuation

The scenario

My wife and I are accountants and started a small practice in partnership (equal shares) in November 2006. In March 2009, we transferred our partnership into a limited company.

I hold a 75% share, and my wife has 25% (she is less involved than in the partnership).

The first year of trading through the company saw turnover double over the last year of the partnership's trade.

We are preparing the company's first accounts and I would value readers' views on the principles of creating and valuing the goodwill on incorporation and whether this can be sold to the company to allow drawing on director's loan account and the amortisation under FA 2002, Sch 29 paras 117 and 118.

At a recent seminar it was suggested that one of the most commonly used methods to value the business is to take the net profit figure (after taxation) and multiply it by a pre-set multiplier figure.

Exactly how much that should be is debatable, but it could be between four and eight.

Query 17,617 – Macaroni

Reply from The Snark

Goodwill to transfer

The Snark was fairly pessimistic:

> 'HMRC take the view that much, if not all, of the goodwill attaching to any small business derives from the skills, abilities and other personal attributes of the proprietors.
>
> If a third party were to purchase this business, there is every likelihood that the buyer would want an ongoing commitment from the proprietor to continue working in it to secure the goodwill. This is demonstrable evidence that it is personal to the proprietor.
>
> So the transfer of goodwill to the company might be a nice idea, but often the scope to do it is severely limited.'

What is it worth?

The Snark identified the following key points:

- The usual way of valuing the goodwill of most small businesses is on a multiple of maintainable profits (suggesting a multiple of around 2 given the current climate)
- Allowance should be made for such things as proprietorial remuneration, with weighting applied over the years so that more emphasis is given to more recent figures
- Accountancy practices are usually sold on the basis of gross referring fees with the multiplier being much smaller (0.75 was suggested)

Reply from Hodgy

Goodwill to transfer

Hodgy took a more optimistic view on 'personal' goodwill arguing that:

> 'if this was a 'normal' accountancy practice largely based round accounts preparation and tax returns, then the value of personal goodwill should be minimal.
>
> There are a lot of people out there who can do that job and the personal skills of the proprietor will only be one of a bundle of reasons why a client uses them.
>
> There are a number of sole-trader accountants in the UK who have no employees and they are perfectly able to sell their clients and be paid for the goodwill of their practice in the same way as a more substantial business where there are a number of employees.
>
> The goodwill of those practices is unlikely to be personal goodwill and this is not likely to be a problem for Macaroni.'

Valuation

When looking value goodwill, Hodgy:

- identified applying a mulitple to maintainable profits as being the most commonly used method with adjustments (between 3 and 5)
- suggested similar adustments were appropriate
- proposed the idea of using a weighted average of mainatinable profit to reflect the speed of growth
- Confirmed that accountancy practices commonly apply a multiple to recurring fees rather than profit
- Suggested using a broker to get an idea on the current multiple of recurring fees that is being paidand comparing this with the value obtained by applying a multiple to maintainable profit.

Reply from Mick Ruse

Mick Ruse suggested a multiple of gross fees of around 0.75 to 1 times of gross recurring fees but introduced the idea of another, what he said was, more prevalent method called the ‘super-profit’ method.

Broadly, the ‘super profit’ is the transferable profit before partners’ drawings less the commercial value of their services:

- Realistic multiple of pre-tax super profit likely to be between three and five, with three being appropriate for a small business.
- He claimed that this wass not that dissimilar to the post-tax multiple of four to eight suggested to Macaroni

Corporation Tax

Release of loans to close company participators

Where a loan is made to a shareholder director of a close company (and this includes an overdrawn current account balance), there are two main tax consequences:

(i) A charge arises on the company under S455 CTA 2010. This is currently levied at the rate of 25% (notice that this has *not* been increased to 36.11% – the new top rate of tax for dividends) of the loan advanced and is due nine months after the end of the accounting period in which the loan was made. When the loan is repaid, HMRC refund the S455 CTA 2010 tax but not until nine months after the end of the accounting period in which the loan was repaid. Partial repayments attract a pro rata refund. Therefore, as long as a loan or an overdrawn current account balance is made good prior to the relevant corporation tax payment date, there will be no S455 CTA 2010 charge.

(ii) Shareholder directors will also be liable to a benefit in kind charge under the beneficial loan provisions of S175 ITEPA 2003 to the extent that they do not pay interest on the loan or advance at a commercial rate (since 6 April 2010, this has been set at 4%).

In addition, there are special provisions which apply if a loan to a shareholder director is released or written off by the company. By virtue of S416 ITTOIA 2005, income tax is charged on the amount released or written off, grossed up at the 'dividend ordinary rate' of 10%. If relevant, further tax is due at the difference between 32.5% (or 42.5%) and 10%. In other words, the waiver is treated in much the same way as dividend income.

It should be emphasised that the charge under S416 ITTOIA 2005 takes precedence over the benefit in kind rules for a loan waiver in S188 ITEPA 2003 (S189 ITEPA 2003). This means that the maximum effective rate of income tax is only 36.11% and there may also be no NIC charge.

When such a loan is released or written off, the company is nowadays able to recover the S455 CTA 2010 tax which it had previously paid to HMRC. This tax is due for repayment nine months after the end of the accounting period in which the loan waiver took place.

Another important point concerns the corporation tax treatment of the loan write-off. There are two ways in which companies have in the past attempted to claim corporation tax relief for the amount waived:

- The first was to treat the waiver as part of the company's employment costs. However, this was subject to the normal requirement that the amount waived could not be excessive in relation to the services provided by the director to the company (with a close company, this was usually easier to justify).
- The second line of attack involved the use of the loan relationship rules originally set out in FA 1996 (but see now CTA 2009). The repeal of S87(3)(c) FA 1996 by Para 7 Sch 25 FA 2002 for accounting periods beginning on or after 1 October 2002 means that a shareholder director is no longer treated as connected with his company for loan relationship purposes. As a result, the release of a loan to a shareholder director was potentially deductible under the loan relationship legislation as a non-trading deficit – it was a *non-trading* deficit because the company's normal business was presumably not the making of loans. The tax treatment of non-trading deficits is detailed in Ss456 – 463 CTA 2009. The position was that a company could claim, within a two-year time limit (see S460 CTA 2009), that such a deficit should be offset:
  - against its total profits for the current accounting period; and/or
  - against its profits from loan relationship activities for the previous accounting period.

To the extent that the deficit was not dealt with as above, it was carried forward and set against *non-trading* profits of the company for subsequent accounting periods. These rules are described in Para CTM50820 of the Company Taxation Manual.

By virtue of S43 FA 2010, a new S321A CTA 2009 has been introduced with effect from 24 March 2010. It prohibits a tax deduction in the company for the cost of writing off a loan or advance under S455 CTA 2010. However, this only appears to apply for the purposes of the loan relationship rules! The key words of the new anti-avoidance legislation are:

> 'No debit is to be brought into account for the purposes of *this Part* in respect of the release or writing off' (the speaker's italics).

It will therefore continue to be possible to obtain corporation tax relief via the 'wholly and exclusively' provisions of S54 CTA 2009.

Despite these difficulties, a loan waiver is anyway a useful tax planning device. The disadvantage of paying a dividend as a means of remuneration is that it must be paid to all shareholders of that class, irrespective of their contribution to the company's success. If it is desired to direct a payment to only one individual, it may be worth considering making a loan to that individual and subsequently writing it off. To all intents and purposes, the individual is treated as though he had received a dividend, even though the other shareholders have received nothing. However, in this situation, the need for correct documentation, including a formal deed of waiver, cannot be stressed too highly.

Contributed by Robert Jamieson

Lecture B604 (26.54 Minutes)

Dividends that qualify, and dividends that don't

We have now got a new tax exemption for dividends received by companies. It arrived on 1 July last year and covers virtually all dividends ... or does it?

Finance Act 2009

This introduced s. 931A, which says:

1) The charge to corporation tax on income applies to any dividend or other distribution of a company, but only if the distribution is not exempt.
2) Subsection (1) does not apply in the case of a distribution of a capital nature.

Dividends of a capital nature

If the dividend does have a capital nature, it cannot qualify for the dividend exemption and we would then need to consider the chargeable gains regime.

Reserve creation

Commonly this has occurred where the group's UK parent runs short of distributable reserves from which to pay dividends to its public shareholders. To solve the problem, they have inserted a new sub-holding company between the parent and all the subsidiaries, on a share-for-share exchange with the intermediate company then applying to the Companies Court to reduce the amount paid on its share capital and for a declaration that the reserve so created is distributable.

The reserves so created could be paid to the parent, but if they were to be distributable to shareholders, the intragroup dividend would need to be financed with third-party debt taken on at the sub-holding company, or at its subsidiaries.

All this really does is revalue the group's assets in the parent company's books, since the amount ultimately distributable is usually the difference between the group's fair market value and the subsidiaries' carrying value in the parent's books.

Clearance refusals

However, I've seen several recent clearance refusals, where HMRC consider that the dividend from the sub-holding company is a capital dividend, since the reserves came from that company's share capital. The result is thus that the dividend exemption doesn't apply, and the group needs to consider whether the substantial shareholding rules exempt the parent from charge.

Liquidating dormant subsidiary

A second common example is where a group decides to liquidate a long-standing dormant subsidiary. No-one can recall the base cost of its shares, so it reduces the paid-up capital to virtually nothing, pays a dividend and is then liquidated. Under HMRC's new analysis, the dividend achieves nothing, since it's taxed as capital.

Legal form over substance

Similar challenges can arise with dividends from overseas. The long-standing *Rae v Lazard Investment Co* principle will apply in considering the legal form, but perhaps we don't always recall all the details of the case – which concerned a demerger by partial liquidation under Maryland law. Lord Reid stated: 'In deciding whether a shareholder receives a distribution as capital or income, our law goes by the form in which the distribution is made rather than by the substance of the transaction.

Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation.'

He then added that the question is 'whether ..."the capital of the possession" did or did not remain intact after the ... shares were distributed: or whether the ... shares were merely fruit or had they in their fall taken part of the tree with them'. The House of Lords concluded that since Maryland law treated the partial liquidation as capital (and the demerger could have taken place as a dividend), UK tax law should follow that capital treatment. They distinguished the earlier case of *Reid's Trustee,* which held that dividends paid from income or capital profits will remain income to the recipient.

We also need to recall *Sinclair v Lee* – the case about the ICI/Zeneca demerger, which took place as an exempt dividend. The question before the court concerned a trust – should the Zeneca shares' dividend go to the income beneficiary, or the capital beneficiary? The court held that the dividend was in substance capital and that it should go to the capital beneficiary.

From an article by Bill Dodwell

B&E Security Systems Ltd

The taxpayer company installed, maintained and monitored intruder alarm systems. It also operated a control room containing sensitive surveillance equipment at an undisclosed location in the UK.

In its 2001 and 2002 accounts, the company claimed capital allowances in respect of equipment and control room expenditure. HMRC decided that the control room expenditure did not qualify as plant and machinery within CAA 2001, s 25, and denied the claim.

The tribunal noted that the core business of the appellant company had altered when it decided to take on sensitive surveillance work.

This contract had required the company to create a custom-built control room from the surveillance could be carried out. It seemed significant to the tribunal that the works on the control room were only needed because the company had taken on the surveillance work.

Having won that contract, it was necessary for the company to carry out the work. It was also notable that the company had little discretion as to the precise extent of the work: i.e. the work had to comply with a relevant British Standard and the company was subject to annual inspections from the customer.

Considering the facts of the case, the tribunal felt there was a sufficient nexus between the expenditure incurred by the company on the control room and that in respect of the acquisition of the security equipment as to make the former incidental to the latter.

So the expenditure on the control room would not have been incurred without the expenditure on the equipment, and vice versa.

The taxpayer company's appeal was allowed.

Value Added Tax

VAT tuition exemption – sole trader, partnership or corporate?

Background

Item 2 Group 6 Sch.9 VATA 1994 exempts "the supply of private tuition, in a subject ordinarily taught in a school or university, by an individual teacher acting independently of an employer". This is the UK's transcription of art.132 (j) 6th Directive: "tuition given privately by teachers and covering school or university education".

The precise meaning of these expressions has been tested a number of times in the courts, including several recent cases. It is important for several different parties to the transaction:

- a pupil who is paying for education is likely to want not to pay VAT, because they cannot generally recover it – they will prefer to receive education that is within the exemption;
- a college which is providing education to pupils will want to be within the education exemption, but will then prefer not to incur input tax on expenses, including the cost of hiring self-employed teaching staff;
- a college which is providing education to businesses or to public bodies will prefer not to be within the education exemption because their customers can recover VAT – so charging VAT to the customers does not increase their cost, but rather allows the college to recover its own input tax;
- an individual teacher who operates on a self-employed basis has to consider whether to charge VAT or not – depending on what the teacher does, the business could be wholly or partly exempt or wholly taxable.

If an individual wants to run a self-employed business in this area and have any chance of enjoying the exemption, it appears to be necessary to operate in unincorporated form. It is common for individuals to set up personal companies to run their businesses for them, and this can have significant benefits for income tax and NIC – but it might cost a great deal in VAT, if the exemption is desirable and available otherwise.

Conditions for education exemption – cases

Clarke

Two partnerships provided tuition in ballroom dancing. Customs issued assessments charging tax on their income. The partnerships appealed, contending that the tuition qualified for exemption under VATA 1994, Sch 9, Group 6, Item 2. The Tribunal accepted this contention and allowed the appeals.

The fact that the teachers were members of partnerships did not alter the fact that the tuition was provided by an 'individual teacher acting independently of an employer' within Item 2. As long as the partner was the teacher, the course fell within the exemption.

VAT Tribunal (15,201): C & E Clarke; A & H Clarke

Customs issued Business Brief 1/98 to set out their practice following this decision. The policy is now found in the Customs manuals at Chapter 21 Education:

The Clarke School of Dancing Tribunal decision

Current policy has been heavily influenced by the Tribunal decision in the Clarke School of Dancing (LON/96/1446 & 1447) case.

In this case the point at issue was whether supplies of dance instruction by a partnership qualified for exemption under item 2 as 'tuition by an individual teacher acting independently of an employer'. The Tribunal rejected the argument that the Clarkes were not giving tuition privately because, as a partnership, they formed part of an organisation. Instead it found that the partners in both partnerships gave the tuition as principals and on their own behalf. The fact that they were partners did not change the position: as partners the Clarkes were still individuals carrying on business.

The scope of the exemption for private tuition

When an individual teacher supplies education or training in a personal capacity or as a member of a partnership the supply is exempt under item 2, provided that the instruction is in a subject ordinarily taught in a school or university.

What does 'ordinarily' mean?

A reasonable test for 'ordinarily' is whether the subject is taught in a number of schools or universities on a regular basis. In practice, the vast majority of structured courses delivered by an individual teacher are likely to meet this criterion.

Conditions that do not preclude exempt treatment

For the purposes of this exemption it is irrelevant whether the individual teacher:

- delivers the instruction to one person or to a group;
- contracts with an individual, or with an organisation that makes an onward supply of the educational services; or
- works under a franchise agreement that allows him or her to use the teaching methods, name or trading style of another person or organisation.

Sporting and recreational activities

Instruction and coaching in sporting and recreational activities qualify as exempt private tuition, provided that the supply meets all the other necessary conditions.

Motorcycle and car driving instruction

Because of the 1992 Tribunal decision in TK Phillips, motorcycle lessons are likewise potentially covered by this exemption. However, we currently hold that car-driving lessons, carried out on public highways, are not a subject ordinarily taught in a school or university, so are not covered by this exemption.

Tuition delivered partly by the individual teacher and partly by someone else

In principle, private tuition is exempt when supplied by either a sole proprietor or any member of a partnership. In line with the Tribunal decision in Clarke (see paragraph 7.2) such tutors qualify as an 'individual teacher acting independently of an employer'.

However, the exemption does not extend to instruction delivered by anyone employed or engaged to help. In these circumstances, the sole proprietor or partnership may opt to use any fair and reasonable method to apportion their supplies between exempt and taxable elements – see J.A. Charles & S.L. Charles (Lon/01/1242).

If this is impractical, they may treat all their supplies of tuition as taxable, regardless of who actually delivers it.

If a sole proprietor or partnership employs or engages others in a nonteaching capacity, this has no effect on the liability of the tuition they themselves supply.

Can exemption cover supplies made by a limited company?

Where a teacher is employed by a company to perform teaching, those supplies are not exempt as they are not made by an individual teacher acting independently of an employer. This applies even if the teacher concerned is the sole shareholder of the company. Goods or services provided in connection with private tuition

Goods or services provided in connection with private tuition

No exemption is available under Group 6 for separate supplies of goods and services closely related to the supply of private tuition even when those supplies are for a clearly educational purpose. The sole proprietor or partnership must treat them as taxable unless relief is available elsewhere.

Tutorial colleges (sometimes referred to as 'crammers')

These are institutions that specialise in preparing students for examinations, usually provided by an Examination Board, professional body or recognised provider of professional qualifications.

Crammers normally but not always operate on a commercial basis for profit and as such will not usually qualify as eligible bodies under item 1.

Liability of supplies

The education that crammers provide is unlikely to meet the requirements for exemption as private tuition.

Even where a sole proprietor operates the crammer, he or she will usually employ or engage others to help deliver the tuition. Where this happens, the sole proprietor may opt to exempt the tuition he or she personally delivers, whilst treating as taxable the tuition carried out by other people. See paragraph 7.4.

Teachers teaching in their own capacity

In some tutorial colleges each teacher may be contracted to teach in their own capacity direct to pupils. In that case their supplies are exempt. You should examine contracts to establish the true position.

Empowerment Enterprises

The UK's rule has been interpreted to mean that an individual tutor acting as a sole trader could benefit from the exemption, but the same person acting through a limited company could not, because the tutor would now be an employee of the limited company.

A trader questioned whether the UK provision was consistent with the 6th Directive. He had been involved in two previous Tribunal cases, John Page t/a Upledger Institute (16,650) and John Page Empowerment Enterprises Ltd (18,820). In the first, his counsel had accepted that incorporating what was then a sole trade would lose the exemption; by the time of the second, he had incorporated, and that case concerned various arguments about state aid and the status of universities that were dismissed by the Tribunal. The current case was the more important question of how the exemption should be applied to different types of legal entity.

The Tribunal examined the precedents very carefully, and a number of analogies relating to different exemptions, and decided that the exemption should apply to the activity rather than to the person carrying it on. In this case, the activity referred to in the 6th Directive – applying the normal English meanings of the words – was face-to-face tuition by a tutor to pupils in subjects ordinarily taught in schools or universities. There was no justification for the UK law's reference to "acting independently of an employer", nor was there any justification in drawing a distinction between different legal forms of entity.

HMRC argued that an incorporated business could not be a "teacher" – if the supply was made by a company, it did not fit the description in the Directive. But the Tribunal did not accept that argument. The supply might be made by the company, but the tuition was still provided by a teacher. The appeal was allowed at the first instance.

The Court of Session later overturned the Tribunal's decision. The Court was more impressed with HMRC's analysis of the exemption for education generally in Art.13A(1)(i) (now art.132(i)) and its relationship with the exemption for private tuition in Art.13A(1)(j):

"(i) children's or young people's education, school or university education, vocational training or retraining, including the supply of services and of goods closely related thereto, provided by bodies governed by public law having such as their aim or by other organisations defined by the Member State concerned as having similar objects;

(j) tuition given privately by teachers and covering school or university education;"

The member state is allowed (by Art.13A(2), now art.133) to impose extra conditions (e.g. not-for-profit status) on those bodies qualifying for exemption under (i), but not those qualifying under (j). HMRC's analysis made much more sense of this distinction. The reference to "tuition given privately" indicated an individual teacher acting in a personal capacity.

The company's argument that this violated the principle of fiscal neutrality (because different legal structures would have different VAT liabilities for the same supplies) was less persuasive.

Court of Session (2006): HMRC v Empowerment Enterprises Ltd

Customs responded to this decision with the usual advice to anyone who had relied on the Tribunal's ruling to exempt supplies that are now found to be taxable: they should correct errors of up to £2,000 on the next VAT return, or make a voluntary disclosure of larger errors (the £2,000 limit has since been raised to £10,000, but anyone relying on this Tribunal decision should have corrected their mistake some time ago).

Business Brief 16/06: Supplies of staff in European law

In 2007, the ECJ gave rulings on two related cases:

1. one from the Netherlands, which concerned a supply of staff by one school to another school;
2. one from Germany, which concerned the supply by an individual self-employed teacher to a school.

In the first, the judgment was that:

Article 13A1(i) is to be interpreted as meaning that the expression "children's or young people's education, school or university education, vocational training or retraining" does not cover the making available, for consideration, of a teacher to an educational establishment, within the meaning of that provision, in which that teacher temporarily carries out teaching duties under the responsibility of that establishment, even if the body which makes the teacher available is itself a body governed by public law that has an educational aim, or another organisation defined by the Member State concerned as having similar objects.

Article 13A1(i), read in conjunction with Article 13A(2), is to be interpreted as meaning that the making available, for consideration, of a teacher to an educational establishment in which that teacher temporarily carries out teaching duties under the responsibility of that establishment, may constitute a transaction that is exempt from value added tax on the basis that it is a supply of services 'closely related' to education, within the meaning of Article 13A1(i), if such a teacher placement is a means of better enjoying the education deemed to be the principal service, provided, however – which it is for the national court to verify – that both that principal service and the placement which is closely related to it are provided by bodies referred to in Article 13A1(i), taking into account, where appropriate, any conditions which may have been introduced by the Member State concerned pursuant to Article 13A(2)(a); that placement is of a nature and quality such that, without recourse to such a service, there could be no assurance that the education provided by the host establishment and, consequently, the education from which its students benefit, would have an equivalent value; and the basic purpose of such a placement is not to obtain additional income by carrying out a transaction which is in direct competition with commercial enterprises liable for value added tax.

In the second case, the ECJ ruled:

The activities of an individual acting in a freelance capacity, consisting of providing assistance with schoolwork and also running ceramics and pottery courses in adult education centres, can be exempted from value added tax under Article 13A(1)(j) only where such activities consist of tuition given by a teacher on his own account and at his own risk, and covering school or university education. It is for the referring court to verify whether that is the case in the main proceedings.

ECJ (Case C-445/05): Werner Haderer v Finanzamt Wilmersdorf; (Case C-434/05) Stichting Regionaal Opleidingen Centrum Noord-Kennemerland/West-Friesland (Horizon College)

Recent cases

A German engineering firm operated as a partnership. One of the partners was responsible for running courses at a university, and the firm derived income from his activities. The tax authorities ruled that this was VATable, but the firm argued that he was self-employed and therefore within the exemption provided for by art.13A(1)(i) or (j) 6th Directive.

Questions were referred to the ECJ on two issues:

1. whether the activities of the partner, which included administration of the courses and acting as an examiner, fell within "tuition";
2. whether the partner could be regarded as giving tuition "privately".

On the first issue, the ECJ ruled that the whole activity could be regarded as tuition, provided that it was all carried out in the context of the transfer of knowledge and skills between a teacher and pupils or students. Exemption would not be denied on that ground.

However, on the second issue, the ECJ ruled that the arrangement did not qualify for exemption. As the partner was presenting courses offered by a different body (the university), he could not be regarded as giving tuition "privately". The firm's income was therefore subject to VAT.

ECJ (Case C-473/08): Ingenieurburo Eulitz GbR Thomas und Marion Eulitz v Finanzamt Dresden I

Similar issues were considered by the UK Tribunal in a case concerning two golf professionals. One provided tuition as a member of a partnership (exempt) and as a director of a company (taxable); the other as a sole trader (exempt) and as an employee of the same company. The company appealed against HMRC's refusal to treat its supplies as exempt.

The appellant's representative (BJ Rice, who won a case in the Court of Appeal in the 1990s) argued that the principles of fiscal neutrality were infringed by the different treatment of what were essentially identical supplies.

The Tribunal concluded that the EU law was clear in its meaning, even if the reason for the distinction between employment and self-employment was not obvious. Mr Rice was trying to use a principle "to override a rule rather than to interpret a rule. This is not permissible." The Tribunal was satisfied that the UK law had correctly transposed the Directive.

First Tier Tribunal (TC00323): Marcus Webb Golf Professional

Education, but ineligible body

A company provided training in IT. It did not register for VAT, and appealed against a notice of compulsory registration on the grounds that its supplies ought to be treated as exempt within Group 6 Sch.9 VATA 1994. The Tribunal agreed with HMRC that it was not an eligible body within Note 1(e) which requires that a body is only eligible if it (i) is precluded from distributing and does not distribute any profit it makes; and (ii) applies any profits made from supplies of a description within this Group to the continuance or improvement of such supplies.

The company's constitution prohibited the distribution of a profit, but it made a substantial amount of money which was paid to the directors (who were also shareholders) as remuneration. The Tribunal concluded that it was therefore a commercial organisation whose purpose was to make a "profit" that would be distributed as pay rather than as dividends. The appeal was dismissed.

First Tier Tribunal (TC00192): Trans Medium Ltd (t/a Connectivity)

Contributed by Mike Thexton

Lecture B605 (22.42 Minutes)

Grimsby College Enterprises Ltd v Revenue and Customs Comrs

The appellant was a company wholly owned by an educational charity (the institute). The appellant was set up in 1993 for the purpose of undertaking commercial profit making activities designed to provide the institute with additional funding. The educational activities carried on at the institute consisted of teaching students whose education was wholly or partly grant funded, and students who were employees of the appellant's customers, whose education was provided in consideration for contractual payments made by those customers to the appellant. In 2001, the institute's governors decided to build and equip a new engineering centre. Initially, and without tax advice, the Institute entered into the requisite building and consultancy contracts. The Institute erroneously assumed that the construction work would be zero rated. Tax advice obtained thereafter was to the contrary. The institute and the appellant attempted to re-arrange affairs whereby the construction work would be supplied to the appellant, so that it could recover as input tax the VAT charged by the builders and consultants. The advice was that: (1) there should be a novation of the building and consultancy contracts; and (2) that the institute should grant a lease of the site of the new building to the appellant. The appellant and the institute entered into a written contract described as a licence to use facilities at the new building, by which the appellant purported to grant to the institute a right to share the use of the equipment within the building on a non-exclusive basis. The appellant argued

before the tribunal that the transactions should be VAT exempt. The judge found that the institute had failed properly to implement the tax advice to carry out a novation, with the consequence that the judge held that the supply of the construction work was made to the institute rather than to the appellant, and would incur VAT. By contrast, the company undoubtedly purchased the equipment. The judge held that as the appellant had received the supply of the equipment, the VAT which it paid in connection with it was input tax in the appellant's hands. However, the ability of the appellant to recover the input tax paid in relation to the acquisition of equipment depended on whether the supply of the use of the equipment and, by necessary implication, the building, pursuant to the licence was not a "licence to occupy land" within the meaning of Item 1 in Group 1 within Part II of Schedule 9 to the Value Added Tax Act 1994, and therefore an exempt supply. The judge found that the licence was a "licence to occupy land", and held that the tax paid by the appellant in connection with the acquisition of the equipment was unrecoverable. The appellant appealed.

The appellant argued that the judge had been incorrect to conclude that licence conferred any right of occupation of the building upon the institute.

The right to occupy an area or space for a period of time might not be a letting of immovable property if it were merely the means of effecting the supply which was the principal subject matter of the relevant agreement (see [16] of the judgment).

The terms of the licence were drafted with a view to avoiding the consequence that the licence constituted a letting of immovable property. At face value, the licence was predominantly for the use of the machinery rather than for the building. It was only by implication that it constituted any licence to use the building at all. However, the judge's finding of fact about the arrangements actually put into place with regard to the use, control and management of the building demonstrated that the provisions of the licence did not in fact represent the real bargain made between the parties. He regarded the provisions as an artifice designed to present to the Revenue a picture of the relationship between the parties very different from that actually agreed. It was not a case in which a genuinely agreed right to require the licensee to submit to the licensor's management, control and imposed sharing of the subject property was simply not implemented thereafter. It was a case where the institute was intended to be in control of the whole of the educational activities within the building. The facts found by the judge clearly demonstrated that the reality of the arrangement masked by the provisions of the licence was that the appellant had granted the institute a right of occupation of the building, rather than merely a right of use, either of the building or the machinery (see [20]-[27] of the judgment). The appeal would be dismissed.

Paola Sassi

Ms Sassi is an expert in sustainable architecture. She was invited to teach a course at Cardiff University and sought accommodation in the area for use during the week, eventually finding a plot with planning permission for a single home.

Ms Sassi considered that it would be more environmentally friendly to build two flats than one house and resolved to construct a "super-insulated, zero-heating" building. Because no contractor could be found to carry out the project on its own, Ms Sassi bought in the required services piecemeal and thus became a DIY builder.

It was always Ms Sassi's intention to live in one flat and let the other. HMRC therefore concluded that development of the flat to be let was carried out in the course of a business, thus preventing Ms Sassi from recovering VAT incurred under the DIY builders' scheme in respect of that part of the project.

In *CCE v Yarburgh Children's Trust* [2002] STC 207, Mr Justice Patten said, at para 25, that "In my judgment the mere fact of the letting at a rent is not sufficient in itself to render that transaction an economic or business activity".

Accordingly, the Tribunal considered the six indicators of a business described in *CCE v Lord Fisher* [1981] STC 236:

1 whether the activity was a serious activity earnestly pursued

2 whether the activity is an occupation or function which is actively pursued with reasonable or recognisable regularity

3 whether the activity has a certain measure of substance in terms of the quarterly or annual value of the taxable supplies made

4 whether the activity was conducted in a regular manner and on sound and recognised business principles

5 whether the activity is predominantly concerned with the making of taxable supplies to consumers for a consideration

6 whether the taxable supplies are of a kind which, subject to differences of detail, are commonly made by those who profit from them.

Before seeking to apply the indicators it was first necessary for the Tribunal to determine the nature of the activity itself.

In its view this was not a case where the sole activity to be analysed was that of letting one of the flats for an income. It was bound, particularly in the case of an isolated letting, or infrequent transactions, to consider that letting in its context. Here there was a letting of a single dwelling, and although it was Ms Sassi's intention that the lettings of that dwelling would be ongoing (in the sense that as one tenancy expired it would be renewed or replaced by a new tenancy with the existing or a new tenant), the Tribunal considered that this case fell at the isolated or infrequent end of the spectrum. The activity went further than that of a person who had simply built a property and let it out for income. Ms Sassi had done that but her activities, both in the construction phase and subsequently, also included designing and creating a sustainable building for use not only as a dwelling but for ongoing research and academic activities. It was in this context that the Tribunal considered whether, taken as a whole, the activity amounted to a business for VAT purposes.

It concluded from the facts that the activity was a serious one (indicator 1), pursued with reasonable and recognisable regularity (indicator 2). This referred both to the continuing rental income streams and to the research and academic activities. The supplies made, in the form of the letting for rent, did have sufficient substance (indicator 3) and the Tribunal noted that supplies of lettings for rent are commonly made by those who profit from them (indicator 6).

On the other hand, in the Tribunal's view it could not be concluded that the activity as a whole was conducted on sound and recognised business principles (indicator 4). It seemed to the Tribunal that the project was “singularly lacking in commerciality, being more concerned with the environmental and sustainability issues than with those of commerce”. This was demonstrated by a consideration of the project as a whole, by the facts that the cost of the project exceeded its market value and that the first letting was made to one of Ms Sassi's students at less than a market rent, rather than her taking a third-party tenant.

Nor did the Tribunal consider that, viewed objectively, the overall activity was predominantly concerned with the making of supplies for a consideration (indicator 5). (Incidentally, the Tribunal was satisfied that the reference in *Lord Fisher* to the making of “taxable” supplies was not intended to draw any distinction for this purpose between taxable supplies and, as in this case, exempt supplies, such as the letting of a dwelling.) In this case, having regard in its context to the activity as a whole, which included both the making of exempt supplies and the activities of research and academic study that did not involve such supplies, the Tribunal concluded that the predominant nature of Ms Sassi's activity overall was not the making of supplies for a consideration.

The Tribunal then considered the relative weight of the various indicators in this context. It did not think the indicators which were met were on their own conclusive of business activity. Moreover, the fact that the activity as a whole was not conducted on sound and recognised business principles and was not predominantly concerned with the making of supplies for a consideration outweighed the other factors and was decisive of the fact that the overall activity was not a business.

The Tribunal concluded that for the purpose of s 35 the works carried out by Ms Sassi were carried out otherwise than in the course of any business. The appeal was therefore allowed.