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Personal Tax

Settlements and "B" Share dividends

In an appeal featuring a husband and wife, dividends and different share classes, HMRC raised questions about the laws involving business, marriage and settlements.

The case began when an engineering business, founded by Mr Henson in August 1978, changed ownership after a share sale agreement was entered into on 14 January 2000.

It was purchased by the appellant and his wife, Mr and Mrs Patmore and had been funded by a mortgage on their jointly-owned matrimonial home.

Mr Patmore's ownership increased by 83 shares, leaving him with 98% of the shareholding as well as making him the sole director. His wife on the other hand received two shares, thus giving her a 2% shareholding as well as the title of company secretary.

On 31 March 2000, a meeting took place where the existing 100 shares we re-named A shares. One hundred new £1 shares without voting rights were also created and given the name of B shares.

Ten were allotted to Mrs Patmore. Another meeting the same day the company paid a dividend of £1,900 for each B share. No dividend was paid on the A shares.

Over four years Mrs Patmore received 41.73% of the entire dividend paid which was slightly less than the 42.5% to which she was entitled.

HMRC argued that Mrs Patmore's shares and dividends were caught by anti-income shifting legislation and the dividends were wholly assessable on Mr Patmore.

The judge disagreed, ruling that the disproportionate allocation of the A shares between the couple indicated that there was a constructive trust in Mrs Patmore's favour. She contributed half the capital to buy the shares with her husband.

The B shares were not a fair recognition of her investment as they were effectively without value, i.e. they carried no voting rights or rights to a dividend. Thus a constructive trust arose when the A shares were bought.

The shares were held in law by her husband but on trust for Mrs Patmore. The allotment of the B shares was an inadequate recognition of Mrs Patmore's investment, but it was neither commercial nor gratuitous. The shares were therefore not settled on Mrs Patmore within the meaning of TA 1988, s 660A.

As to whether the dividends were settled on Mrs Patmore, the judge said that these did fall within s 660A because they were not outright gifts. Rather, they were a gift of a right income.

The judge ordered that the assessments be reduced to reflect his decision.

The taxpayer's appeal succeeded in part.

David Patmore (TC619)

Rental income on separation

The following question and answers appeared in Taxation Forum in September 2010.

"My clients Mr and Mrs N have recently separated. Mr N has left the family home where his wife remains with their two children, aged 11 and 21. He has also given another property, a shop, to Mrs N, the idea here being that the rental income should go to the children for their school fees and maintenance.

The rental income goes into Mrs N's bank and she uses this income for the children according to Mr N's wishes. In the near future, Mrs N will start to receive income from a new employment and will be liable to tax on this.

I am thinking of dividing the net rental income from the shop between the two children, who would then be liable for tax on any income in excess of their personal allowances, which are currently unused.

Is this a practical solution to minimising the family tax liabilities?"

Reply from Graham Wilde, TaxNetUK Ltd

The first question to ask is who 'beneficially' owns the shop and in what capacity. Although legal title may have passed into Mrs N's name, we are told she is acting in accordance with Mr N's wishes!

If it transpires that Mrs N is simply to hold the shop in her name only, probably due to the young age of at least one of the children, but is to use the income for the education and maintenance of both children, then to pass on the capital value of the shop at some stage in the future, it may be possible to argue that Mr N has actually created a bare trust for his two children, with Mrs N and possibly himself, as a result of his input, as trustees.

The creation of a bare trust would therefore have the following effects.

- Mrs N would not have a beneficial interest in the income of the shop, so she would have no need to declare anything on her personal tax return. This could also be beneficial if she is claiming tax credits, as the rents will not increase her level of income.
- The eldest child could indeed receive their share of the income outright and declare this on their personal tax return and thus utilise the personal allowances.
- As a minor, the younger child is in receipt of income from a source, be it direct or indirect, provided by a parent, where that income exceeds £100 per year, then the income will be assessable on Mr N, until that child reaches 18.

However, for capital gains tax, each child would be able to use their annual capital gains tax allowance against the eventual sale of the shop, regardless of their age.

The eldest child could, as it is over 18, call for their share of the capital in the shop now and I am not sure if Mr N would want the eldest child to have that much money at 21 years old. The youngest child could do the same when reaching 18 years of age.

Reply by Terry 'Lacuna' Jordan, BKL Tax

On the face of it, provided Mr N's transfer of the shop to Mrs N was made no later than the end of the tax year during which the separation occurred she will have effectively taken Mr N's base value in the property for capital gains tax purposes in view of the provisions of TCGA 1992, s 58.

As matters stand, the rental income is properly assessable on Mrs N on the premise that she is the beneficial owner. (An alternative analysis is that Mrs N is holding as bare trustee for the children. In that case s 58 would not be in point in view of TCGA 1992, s 60.)

Mrs N might transfer the shop to the children (in practical terms someone would have to hold the legal title as bare trustee for the 11-year old) and that would be a disposal by Mrs N for capital gains tax purposes.

Mrs N would be assessable on the rent accruing for the benefit of the 11-year old until that child attained age 18 or, if earlier, married since the gift would be caught by the 'parental settlement'

provisions in ITTOIA 2005, s 629. (On the alternative analysis above Mr N would be assessable on the income accruing to the younger child.)

Taxation Forum, 15 September 2010

Pool cars for small workforce

The appellant company supplied and fitted industrial doors and security systems and employed a small workforce of approximately six members of staff. In 2009 HMRC issued a decision that the company was required to pay Class 1A national insurance contributions ("NICs") in respect of car and car fuel benefits for two cars, a BMW car and a "4 x 4" vehicle. The company kept no documentation about the use of the pool cars by members of staff—no mileage records or written procedures or logs of any kind were in place—and the keys were kept in a cupboard in the company's premises. The company appealed on the basis that the cars were "pooled cars", which were available to each employee for business travel purposes only, and they met all five of the conditions in ITEPA 2003 s 167(3), which provides: "(a) the car was made available to, and actually used by, more than one of those employees, (b) the car was made available, in the case of each of those employees, by reason of the employee's employment, (c) the car was not ordinarily used by one of those employees to the exclusion of the others, (d) in the case of each of those employees, any private use of the car made by the employee was merely incidental to the employee's other use of the car in that year, and (e) the car was not normally kept overnight on or in the vicinity of any residential premises where any of the employees was residing, except while being kept overnight on premises occupied by the person making the car available to them." The company gave evidence that the cars were parked at or near the business premises and were occasionally taken home overnight by employees when required first thing the next morning. The insurance certificates stated that the permitted drivers were the "policyholder" (the company) and "and person who is driving on the policyholder's order or with his permission provided the driver holds a licence to drive the vehicle or has held and is not disqualified for holding such a licence". On joining the company, the managing director explained the terms of employment which included the pooled car system which applied to every employee for business travel only, with use of the pooled cars for private purposes "strictly forbidden". HMRC argued that no contemporaneous records were maintained of meeting all five requirements of s 167; there were no written monitoring systems and no written arrangements with employees in relation to pooled cars and there was no legally enforceable ban on private use; the need for two pooled vehicles of the cost and standard of car available for a relatively small number of staff was unusual; and the company had not discharged the burden of proof that the conditions of s 167 were met.

The tribunal considered that, although it was clearly best practice to have written records to show that the conditions laid down in ITEPA 2003 s 167 were met, written records were not part of the statutory requirements. In a small environment, in a small office with a few employees, control of the pooled cars could be achieved without formal written rules, although for best practice and to avoid doubt, such records should be maintained. In the instant case insurance was in place and parking space was available and appropriate for a pooled car arrangement. The nature of the appellant's work was consistent with journeys from time to time starting at an employee's home rather than from the business premises. Written statements and evidence were given to the tribunal that the conditions of ITEPA 2003 s 167 were met, albeit that no written records were kept. It followed that the appeal would be allowed.

Appeal allowed.

Industrial Doors (Scotland) Limited v Revenue and Customs Comrs

Closure of sub-post office – termination payment

The issue

This appeal related to the tax treatment of a compensation payment of £74,647.21 ("the Termination Payment") paid by Post Office Limited to the Appellant under the Urban Post Office Closure Scheme (part of the Post Office's Network Reinvention Programme) on 31 March 2005.

The Appellant argued that £30,000 of the Termination Payment should be treated as tax-exempt compensation for loss of office of sub-postmaster and the remainder should be treated as a capital payment to his wife and himself in equal shares in respect of their disposal of the goodwill of their partnership business upon closure of their sub-post office and shop.

HMRC argued that the whole amount should be taxed subject to the usual £30,000 exemption as employment income of the Appellant under s 403 Income Tax (Earnings and Pensions) Act 2003 ("ITEPA").

Background and Facts

The Tribunal accepted that from the outset and at all relevant times, the shop (including the sub-post office) was run by the Appellant and his wife in a 50:50 partnership ("the Partnership").

The post of sub-postmaster was a personal appointment and could not be transferred. The Tribunal found as a fact that the Appellant was the sole holder of the sub-postmaster appointment at all material times; however it also found that the appointment (and the rights under it) was partnership property of the Partnership under s 20 Partnership Act 1890.

The Tribunal accepted that the business of the Partnership (including the operation of the Post Office counter) was carried on by both the Appellant and his wife. In doing so, they were interchangeable.

In a letter dated 16 March 2004 ("the Offer Letter"), Post Office Limited made a conditional offer, addressed to the Appellant personally, to pay what was described in the heading of that letter as a "compensation payment" totalling £70,046.04 if a decision was made, as part of the Urban Post Office Closure Scheme, to close the Post Office branch at the Woodsetton Post Office. The Offer Letter included the following sections:

"Subject to each of the conditions listed in paragraph 1 above being satisfied, Post Office Ltd offers to pay to you on or about your last day of service the sum of £70,046.04, if a final decision is taken to close your branch. This sum represents compensation for loss of office, and all Post Office® business must cease upon your last day of service...."

"We have sought the views of the Inland Revenue on the treatment of the compensation received under the Closure Scheme. The Inland Revenue has confirmed that that part of the total payment which relates to compensation for loss of office will be chargeable to tax under Section 401 Income Tax (Earnings and Pensions) Act 2003 and will attract exemption, up to a maximum £30,000 contained in Sections 403 and 404 of the same Act...."

"The Inland Revenue has also confirmed that that part of the total payment which relates to compensation for loss of office will not fall within the definition of 'earnings' in S3(1)(a) Social Security Contributions and Benefits Act 1992 and will not attract a Class 1 NICs liability."

Decision

The Tribunal found that the Termination Payment was received by the Appellant in his capacity as a partner with his wife in the Partnership. It was partnership property, to which he and his wife were entitled in equal shares. As such, for the purposes of s 401 ITEPA, the Tribunal considers that the Appellant can only be regarded as having "received" one half of the payment. The other half must, in the Tribunal's view, be regarded as having been "received" by the Appellant's wife.

Nonetheless, both halves of the Termination Payment were received "directly in consideration or in consequence of, or otherwise in connection with" the termination of the Appellant's office as sub-postmaster of the Woodsetton Post Office, and accordingly the part of the payment "received" by the Appellant's wife must, since she was his spouse (see s 401(1)), be counted as employment income of the Appellant under s 403.

Since s 401 on its face applies to any payment, irrespective of whether it is revenue or capital in nature in the hands of the recipient, questions of apportionment of the Termination Payment between compensation for loss of office and other compensation are, in the Tribunal's view, simply irrelevant. The whole payment falls within s 401 and 403 regardless of any such apportionment.

Lakbir Singh Uppal

Wilkinson v Revenue and Customs Comrs

In 2002 the appellant, a specialist registrar in urology working within the NHS, began a six-year training programme which involved rotational placements at four different NHS Trusts, and his nominated base hospital was in Winchester. At the outset the appellant was living in Bristol and his first appointment was in Portsmouth. Part of the appellant's entitlement under his six-year programme was a relocation package, entitling him to a maximum £8,000 for the entire period. However as the appellant only sold his property in Bristol in late 2003 when his rotation in Portsmouth was nearly over, he decided to claim "excess mileage" under his relocation package. Accordingly in December 2003 he made a lump sum claim for excess mileage dating back to January 2003 and he was paid £3,416.19 for relocation expenses ("the relocation expenses"). In 2005 the appellant was on his rotation in Southampton and he was paid £633.88 for emergency call-out expenses ("the call out expenses"), being 1,196 miles at 53 pence per mile. In his self-assessment tax returns for those years, the appellant did not include either payment as income from his employment. HMRC opened an enquiry into the appellant's tax returns and thereafter issued notices of assessment under TMA 1970 s 29 in respect of both amounts. The appellant appealed against both those assessments on the grounds that both amounts were exempt from tax under ITEPA 2003 s 287(1), and that the three conditions for emergency calls in HMRC's EIM Manual, EIM10040, were met—ie he gave advice on handling the emergency on receipt of the telephone call, he accepted responsibility for those aspects appropriate to his duties from that time and he had a continuing responsibility for the emergency whilst travelling to his normal place of employment. He argued that (i) he began his duties on receipt of the phone call at home and the whole of his journey was necessary exclusively for his duties; and (ii) the entire programme consisted one single "employment" in which his permanent workplace, within the meaning of ITEPA 2003 s 339(2), was the hospital in Winchester; the other NHS Trusts where he held rotational appointments were temporary workplaces. HMRC argued that (i) each of the four different NHS Trusts constituted a separate employment and that at the time the lump sum claim for "excess mileage" was made, the Portsmouth hospital was his permanent workplace in respect of his then employment; and (ii) the call out expenses were subject to ITEPA 2003 s 62 and the appellant was only responsible for patients once he arrived at the hospital. If he was entitled to the call out fee, then by virtue of ITEPA 2003 ss 229 and 230, he would in any event only be entitled to that deduction at the rate of 40 pence per mile, not the 53 pence that he was in fact paid.

The tribunal found that the issue whether the training programme constituted a single employment, or whether each of the rotational appointments was a separate employment, was not a significant issue.

The tribunal considered that the travel expenses rules in ITEPA 2003 ss 337 to 339 drew a distinction between a "temporary workplace" and a "permanent workplace". Clearly an employee could have more than one temporary workplace. It was also clear from the wording of those sections that, for the purposes of those provisions, an employee could at any given moment also have more than one permanent workplace. Sections 338(3), (4) and (8) made that clear by expressly referring to "a permanent workplace" rather than "the permanent workplace". On the facts, even if the Winchester hospital was the appellant's permanent base, and even if the hospital in Portsmouth was merely one of several rotational placements within a six-year programme, it remained the case that the Portsmouth hospital was in the 2003/04 tax year "a place which the [appellant] regularly attend[ed] in the performance of the duties of the employment" within the meaning of s 339(2)(a), and so the hospital in Portsmouth was treated as a permanent workplace. The conditions for a permanent workplace in s 339(4)(b) were met—ie "the tasks to be carried out in the performance of those duties were allocated there"—in respect of the Portsmouth hospital. There was no evidence to suggest that when the appellant was working in Portsmouth, the tasks that he carried out in the performance of his duties there were allocated to him by the hospital in Winchester, which was under a separate NHS Trust. It followed that the claim for excess mileage

was in respect of the place where the appellant lived and a "permanent workplace". That travel was therefore "ordinary commuting" under either or both of ITEPA 2003 s 338(3)(a) or (b), and therefore was not an allowable deduction from earnings by virtue of s 338(2). Thus the payments made to the appellant for excess mileage were not tax exempt under the travel expenses rules. Furthermore, the payments did not qualify as removal benefits or removal expenses under ITEPA 2003 s 271. On the facts the appellant lived in Bristol before taking up the programme and he then moved to a place near Guildford for about six months. Payments in respect of excess mileage from there to his place of work were not payments in respect of his "former residence" within the meaning of ss 281(1)(c) and 276(2)(a). The payments for excess mileage fell within the general definition of earnings in ITEPA 2003 s 63 and was taxable. The appeal therefore failed to the extent that it related to the excess mileage payment.

The tribunal found that the call out expenses were tax exempt up to the amount of 40 pence per mile, in accordance with ITEPA 2003 ss 229 and 230. Thus of the £633.88 paid to the appellant, £478.40 was tax exempt. The appeal would be allowed to that extent.

Appeal allowed in part.

Interior design business run from director's home

The following question and answers appeared in Taxation Forum in September 2010.

"A limited company trades as an interior design business. Instead of having its own showroom, it uses the director's private residence to display designs.

The company has spent some £20,000 on improvements to the director's house incorporating some of the interior designs – such as a computer-controlled lighting system, as well as designer furniture, joinery and a deluxe bathroom.

Customers are taken round the house to see these design ideas in practice. The overall effect is better than a showroom as it is a real house.

Business has grown considerably and the director is certain that this is due in no small part to the house acting as a 'super showroom'.

However, no advice seems to have been taken before incurring the expenditure and the result seems to be something of a potential minefield of benefits in kind."

Reply from Hart's Content

The benefit arising to the director will be chargeable as such under ITEPA 2003, s 201.

However, there may be scope to reduce the potential charge by looking at ITEPA 2003, s 203 and s 204. Note that the principle in *Pepper v Hart* [1992] STC 898 should apply to the provision of the 'in house' services by the company, but that any supply of goods, rather than just services, there will almost invariably be some additional expense incurred by the employing company.

Section 203 refers to the calculation of the cash equivalent value of the benefit less any amount 'made good'. Making good means giving something in return for the benefit although this is normally money, or something that can be measured in money in a similar way to the benefit is calculated as a cash amount.

Although it could be argued that, by allowing the house to be used as a show home, the director in question is making good, note that in the *Employment Income Manual* at EIM21120, HMRC specifically state that 'the giving of services by the employee, or anything that is not measured in money terms, is not "making good", see *Stones v Hall* [1989] STC 138'.

However, all is not lost for the well-homed director. Section 204 provides for 'a proper proportion of any expense relating partly to provision of the benefit and partly to other matters' to be taken into account in arriving at the cash equivalent.

This enables the expense incurred in providing a benefit to be apportioned where appropriate, and HMRC accept that apportionment is 'normally justifiable' where a benefit in kind is 'used partly for the purposes of the employer's business and partly in providing a benefit to a director or employee'

and at EIM21210 use of the benefit asset(s) by other employees, or by the employer company or hire to third parties, are given as examples of the 'other matters' to be taken into account in an apportionment referred to in s 204.

It should be noted that s 204 is exceedingly brief and there are no 'rules' (statutory or otherwise) for calculating the proportion of cost attributable to different uses but 'the end result should produce an apportionment that is reasonable in the light of the facts of the case and the statutory context in s204'.

Given HMRC's example at EIM21638, some kind of apportionment calculated on the basis of times when the home has been used as a show home (substantiated by customer/sales records) would seem appropriate here.

Reply from Goldstone

The expenditure on fixed assets forming part of the building (designer furniture, bathroom) which when used for either business or private use do not cost him anything. Therefore we need to find out how to treat the benefit that the director has obtained by having these items installed in his private residence, albeit being partly used for the company's business.

The general rule is that the cost of an employment-related benefit is the amount of the expense incurred by the employer in connection with its provision (ITEPA 2003, s 204).

There are special rules for calculating the cost where the benefit consists of an asset made available without transfer of ownership; these rules being displayed under s 205.

Broadly the director would be taxed on the annual value calculated as 20% of the market value of the asset at the time when those providing the taxable benefit first applied the asset in the provision of an employment-related benefit.

HMRC discuss the matter in EIM21630 *et seq*. of *Employment Income Manual*, with EIM21637 ('Assets placed at the disposal of a director or employee: assets used partly for private purposes and partly for work purposes: mixed use benefit'), covering both ITEPA 2003, s 204 and s 205. Relevant comments are:

> 'Note that an asset placed at the disposal of a director or employee represents a benefit (s 205(1)(a)(i)) regardless of the use, if any, to which the director or employee puts the asset.
>
> 'If the benefit is used by a director or employee for private purposes and for business purposes, the business use is not an "other matter" which can be included in the amount of the benefit to be apportioned under ITEPA 2003, s 204. The full amount of the mixed use of the benefit is chargeable to tax, subject to a deduction under ITEPA 2003, s 365(1) for any business use that meets the conditions of ITEPA 2003, s 336 to s 338.'

The final paragraph sums up the position as to calculation of the benefit in kind:

> 'There are no hard and fast rules for calculating the proportion of cost attributable to different uses but the end result should produce an apportionment that is reasonable in the light of the facts of the case and the statutory context in s 204.'

There follow worked examples in the *Employment Income Manual* at EIM21638 and EIM21639.

A closer look... apportionment of 'cash-equivalent' benefits

HMRC's *Employment Income Manual* at EIM21200 provides information on ITEPA 2003, s 204 and 'the benefits code: apportionment of the cash equivalent of the benefit', as mentioned above by Hart's Content.

The manual states that 's 204 provides for "a proper proportion of any expense relating partly to provision of the benefit and partly to other matters" to be taken into account in arriving at the "cash equivalent".

> 'This enables the expense incurred in providing a benefit to be apportioned. For example, apportionment of the annual "cash equivalent" is normally justifiable where a benefit in kind is:

- shared between several directors or employees; or
- shared between a number of individuals only some of whom are directors or employees; or

- used partly for the purposes of the employer's business and partly in providing a benefit to a director or employee (where a benefit is provided to a director or employee to perform the duties of his employment it remains a benefit and not an "other matter to be apportioned". The director or employee is entitled to a deduction under ITEPA 2003, s 365 if all or part of his use of the benefit relates to use for business purposes, but this does not affect the calculation of the cash equivalent of the benefit. All use by the director or employee remains a benefit, whether that use is for business or private reasons); or
- provided only for part of a tax year.

> 'If you have to apportion a benefit, do so on common sense lines based on the facts of the case. For instance, if three directors share a benefit equally between them throughout a tax year, charge a benefit on each director on one-third of the full "cash equivalent" for that year. Do not contend that each of the directors is chargeable on the full "cash equivalent" so as to get tax on three times the full value of the benefit.'

Taxation Forum, 15 September 2010

The implications of the Banerjee case

Dr Banerjee was a specialist registrar in dermatology. Over the five years of the post, she worked mainly for the St George's hospital trust, but a year in the middle was spent with the St Helier trust. The duties of the post were determined by a regional organisation, the South Thames Deanery, who also funded the position.

It was condition of Dr Banerjee's post that she held a 'training number' from the NHS throughout. As part of this commitment, she had to attend courses, lectures and other training events.

Although in some hospitals these courses would either be paid for by the hospital or arranged by them in-house, in her post they were not and she had to meet the costs herself. It was these costs, which she claimed as a tax deduction, that had subsequently been denied by HMRC.

Her supervisor at St George's said in written evidence to the General Commissioners that the specialist registrar post is:

> '… essentially a training post and that the above courses are a condition of their training and thus the duties of the post as dictated by the Regional Deanery. Seeing patients, i.e. the service commitment, is only one aspect of training.'

Performance of the duties

Before the Court of Appeal, the argument for the taxpayer concentrated on the nature of the contract, and therefore of the duties within it. Even though one judge, Lord Justice Pitchford, dissented from the majority verdict, he did not base his judgment on this point, and agreed that training could be part of the duties of the employment:

> 'If the employer requires the taxpayer to spend four days working in a factory and the fifth day, at his own expense and on pain of dismissal, studying in a college, it seems to me unrealistic to deny that expenses necessarily incurred in performing his duty to attend college on the fifth day were incurred in fulfilment of an obligation of his employment.'

For all the judges, the key to distinguishing this case from previous authorities was that training formed a key part of what the employer was trying to achieve. It was not that the theoretical training was some sort of separate requirement unrelated to the 'real' work that she was doing in seeing patients.

It was more the other way round: the reason she needed to see patients was as part of the process of training her to be a consultant. It was the 'practical' which went with the theoretical training and which made up the whole training package.

Wholly and exclusively

The expense also had to be so incurred wholly and exclusively. HMRC's argument was that there was an unavoidable element of personal benefit in taking these examinations, which breached this requirement.

Giving the majority view, however, Lord Justice Rimer read the conclusion of the General Commissioners differently. He acknowledged that they had 'perhaps inconsistently' suggested that Dr Banerjee had a dual purpose, but that the better view of their conclusions was:

> '...no more than that the potential for future professional advancement that she derived from the courses was at most a secondary, or incidental, benefit of her expenditure.'

The reason why Dr Banerjee attended the courses and took the examinations was that she was required to by the contract (and indeed that was the whole point of the training contract).

She would have been sacked if she had not done so. It was therefore artificial to separate out one part of what was intended all along to be a training contract and say that it was not part of the duties of the employment.

So, not without difficulty, the Court of Appeal found on a majority verdict for the taxpayer

There is an alternative

It might be worth just looking at the obvious alternative way this contract could have been structured: namely for the hospital trusts to pay the costs of the training and examinations, and to reduce their salaries accordingly.

The obvious question is why this would not give rise to a charge on the employees as a benefit in kind. The provisions dealing with training are not the same for employers and employees.

If the employer provides 'work-related training' or pays for examination fees and other associated expenses, ITEPA 2003, s 250 prevents a charge to tax arising on what could otherwise be a benefit in kind.

There is no obvious policy reason why the rules for employees getting a tax deduction when they are not reimbursed should be any different from the rules which apply when they are.

The argument put forward is often that the employer's willingness to make reimbursement indicates that the expense is genuine, but in these days of salary sacrifice for childcare vouchers, etc. that seems unrealistic.

Indeed, it suggests a way for all potential specialist registrars to be employed which would obviate the problem. Instead of engaging them directly, they should be employed by umbrella companies which then provide them as staff to the hospitals.

The umbrella company would receive the total salary (increased for secondary NIC), and would meet the cost of the training by reimbursing the doctor tax-free for the expenses incurred. The balance would be paid out as a net salary.

Do we really want tax law to force people to jump through hoops like this? Or would it not be better to ensure that expenditure which would not give rise to a benefit when incurred by the employer is also deductible when incurred by the employee?

From an article by Mike Truman, Taxation 18 August 2010

PAYE problems

Few practitioners will have missed the coverage in the national press regarding the underpayments of income tax under the PAYE system that have come to light as a result of HMRC's new computer system.

It has been suggested that some of these underpayments might be waived by HMRC under extra-statutory concession (ESC) A19.

Information on the concession, which applies where the department has not made timely use of information provided to it, can be found online.

HMRC explain the concession as follows:

> 'ESC A19 states that we will consider giving up arrears of income tax where it [HMRC] fails to make proper and timely use of information received from either the taxpayer, their employer or the Department for Work and Pensions (DWP) where taxable benefits are received.

'The information should be something which allows HMRC to amend the taxpayer's code at the time it was sent. What the taxpayer should do, if they consider HMRC have failed to deal with a piece of information at the right time, is to provide HMRC with details of what it was and what date it was sent to HMRC. HMRC will then check to confirm it was received.

'Finally, all our experience suggests it will only apply in a small number of cases, we don't want to raise people's hopes and see them disappointed later on. It would not be fair to the people we want to help.'

'We can agree not to collect an underpayment if:

we had information which we would use to amend a tax code;

we did not act on that information within 12 months after the end of the tax year we got it;

it is reasonable for us to accept that the customer believed their tax affairs were in order.

'How does the ESC apply to the 2009/10 tax year?

'Normally it would not apply because as a matter of practicality it cannot have been more than twelve months after the end of the tax year in which the information was provided. However, the ESC does allow us to agree not to collect the underpayment for the most recent year if:

- we failed more than once to make proper use of information; and
- the same relief, deduction or allowance is affected.

> 'So, for example, the ESC may be satisfied where the information is, for example, received in 2008/09 and it is not acted on then or in the next tax year.

'Further information on what is and is not information for the purposes of ESC A19 is as follows.

'What is information we would use to change a tax code?

- Details of benefits in kind – P11d or P46(car).
- A new PAYE source from the employer or pension payer – P45, P46
- A new/change to social security benefits from the DWP or Jobcentre plus.

'What is not information for the purposes of ESC A19?

> 'Our policy is that the following is not relevant for the ESC:
>
> - Employer end of year returns – Forms P35, P14.
>
> 'This is because as these returns are received after the end of the year in which the tax code operates we could not have used it to amend the code.
>
> 'Other types of information not within ESC A19 are:
>
> - Details of a change of address.
> - Any other information which would not be used to change a tax code.

Improving the operation of PAYE

HMRC has issued a consultation paper proposing the most radical reworking of the PAYE system in its 66 year history. The public is able to comment on the proposals until 23 September 2010.

The initial catalyst for the changes is the introduction of a new National Insurance and PAYE Computer Service (NPS). This all-singing, all-dancing system should allow an overhaul of many highly inefficient procedures as well as protecting revenues in future. At present, there is no plan to bring benefits in kind into the scheme, although that may change in the future.

NPS

NPS changes the initial premise that tax paying employees are identified by their employer. In future, they will have their own records within NPS and this will have a number of consequences.

There will be a single tax account for each employee and pensioner which will contain a complete personal history in one place. In particular, it will contain an employment history with historic earnings going back to the beginning of their working lives. It will also hold similar records relating to National Insurance Contributions. It is proposed that this will then be updated by employers using real-time information.

Real Time Information

The main benefit that NPS offers is the chance for employers to provide real-time information to the Revenue.

Employers will send pay and deductions information through the electronic payment system on a real-time basis. HMRC can then update its records automatically. For those employers that do not use an electronic payments, new information capture software will be introduced that will enable them to provide the same information and eliminate most of the forms such as P35s and P45s that are currently required.

In introducing this additional computerisation, HMRC hopes to bring about real benefits for all.

- it should reduce fraud, error and overpayment
- tax credits will be integrated into the overall PAYE procedures
- payment information can be updated on a real-time basis
- the headaches and paperwork involved in changing jobs will be removed
- end of year reporting will be eased
- because information is reported automatically administration will be reduced.

Centralised Deductions

A potentially more controversial proposal involves passing a much more significant role to HMRC.

The idea is that the responsibility for paying employees will be outsourced to the Revenue. This will be based on a new Central Calculator that will embrace income tax, National Insurance Contributions and student loans.

It will operate by requiring employers to send gross payments to HMRC, which will then divide them between the amounts that it pays to employees and deductions that it keeps for itself.

There are considerable benefits that can be derived by all from the introduction of centralised deductions.

- it is much more likely that weekly or monthly payments will be correct as they are updated with real-time information
- the system will effortlessly cover multiple employments
- the use of tax codes can be eliminated
- individuals will have direct access to their own records
- in-year corrections will become the norm, for example to take account of gift aid payments
- year-end amendments will be much fewer and further between

- in the fullness of time, self-assessment returns will be provided on a pre-populated basis.

However, there could also be concerns about such a new operation.

- some may feel that it is a sign of a Big Brother state looking to snoop on employees and pensioners
- error resolution could be a real problem with HMRC support lacking
- more HMRC phone lines will be required
- a greater number of properly qualified staff will need to man them
- data security could be a serious issue
- those who enjoy the benefits of the black economy will suffer.

Overall, this project seems to offer a 21st-century package that should generally be welcomed by all except those that do not pay their taxes or make money from the payroll industry. However, the concerns expressed in these notes will need to be addressed before taxpayers can feel entirely comfortable.

Contributed by Philip Fisher

Lecture P616 (10.09 Minutes)

Residence again!

Between 25 August 2003 and 19 September 2005, the appellant, a merchant seaman, worked full-time for a non-UK company in Norway. In compiling his tax returns for those years the appellant claimed he was non-UK resident for tax purposes and his claims were dealt with at HMRC Centre 1 office. His accountants dealt solely with marine workers and seamen and had always previously dealt on their behalf with HMRC South Wales. The accountants' method of calculating the average days spent in the UK, as agreed with South Wales, was to calculate those days from the first day out of the UK to a date beyond 5 April. On that basis they calculated that the appellant had only spent an average of 87.75 days per year in the UK. HMRC did not agree with the method used to calculate the average period spent in the UK and considered it amounted to 91 days or more. They opened an enquiry into the appellant's tax returns and determined that he was resident in the UK in those years. The appellant was accordingly assessed for extra tax during the relevant periods: £8,116.80 in 2003/2004; £16,146.90 in 2004/05; and £14,975.85 in 2005/06. The appellant appealed contending that (i) he had evidence that HMRC South Wales had treated other marine workers and seamen—in exactly the same position as him—as eligible for non-UK resident status. The South Wales office had had consistently (over a 30-year period) agreed, and were still agreeing, non-UK residency on the same basis as his. Had he changed his tax office to HMRC South Wales before submitting his claim for non-UK residence, his claim would have been successful. That was unfair. He had a legitimate expectation that he would be treated exactly the same way as other taxpayers in his position; (ii) his tax office had calculated the average for each tax year separately whereas South Wales' working practice was to calculate the days to the earliest date after 5 April when the taxpayer returned to the UK. Using the split year concession he would qualify for non-UK resident status. Under ESC A11 he should only be taxed up to and including the date of departure and from the date of return to the UK; (iii) if the date of first leaving the UK was changed to 20 January 2004, by ignoring the appellant's first period offshore, then by using the split year concession he would qualify for the non-UK status but HMRC had refused to let them change the start date; and (iv) under TA 1988 s 335 the residence of the taxpayer was determined without considering any place of abode maintained for his use in the UK. HMRC argued that the appellant remained resident in the UK for the following reasons: (i) he kept a home in the UK and no home elsewhere so that his absences abroad were temporary absences with his home remaining in the UK; (ii) all TA 1988 s 335 achieved was to stipulate that when considering whether a person in full time employment outside the UK was resident in the UK, the availability of a place of abode in the UK should be ignored; (iii) the appellant visited the UK for 85 days in 2003/2004 and 97 days in 2004/2005, a total of 182 days. The denominator of the equation for the calculation, as set out in IR20 at para 2.10, was the period from 25 August 2003 to 5 April 2004. The average number of days was 110 which was in excess of the 91 days which would qualify the appellant for non-UK residence in those years; (iv) in the absence of any statutory provision allowing the year to be split, a taxpayer who was

resident in the UK for part of a tax year was chargeable to income tax on the basis of being UK resident for the whole of that year. Although ESC A11 introduced the concept of splitting a tax year into resident and non-resident parts, it was not a concept which the tribunal could take into account as it was a concession and a departure from a strict legal basis; (v) under the provisions of TA 1988 s 334, the appellant's absences were for the purpose only of occasional absence abroad; and (vi) each case had to be dealt with on its own merits.

The tribunal found on the facts that the appellant was resident in the UK for the relevant years. It was not possible to change the appellant's claim to non-UK residence starting from 20 January 2004 because his non-UK employment started on 25 August 2003. On that basis his average days in the UK were more than 91 days per year. Even allowing for the split year treatment as set out in IR20 to apply the average days would still be required to average less than 91 days and unless the appellant's claim had legitimately started on 20 January 2004; his average, as calculated in accordance with paras 2.2 and 2.10 of IR20, exceeded that. The appellant had produced evidence to show that he had not been treated in the same way as other taxpayers in exactly the same position as him, and it was arguable that he had a legitimate expectation that he be treated in the same way as the other taxpayers in his position. The appellant should consider referring his case to the Revenue Adjudicator. The appeal would be dismissed.

Appeal dismissed.

Farquhar v Revenue and Customs Comrs TC 532

[2010] UKFTT 231 (TC)

Furnished holiday lets – more changes on their way

This tax-favoured investment provides many advantages for a property in the UK or EEA - all of which were due to be removed on 5 April 2010 but that did not get through the debate on the Finance Bill 2010. The likely end result is a tightening-up of the qualifying conditions from 6 April 2011 subject to a consultation exercise.

Tax advantages

If a property enjoys furnished holiday let status the tax advantages are as follows:

- CGT entrepreneurs' relief as a qualifying business disposal
- CGT hold-over relief
- CGT roll-over relief
- Income tax relief on losses against general income. However, the 27 July 2010 consultation document proposes that from 2011/12 any losses from the business may only be set against income from the same furnished holiday lettings business.
- Pension scheme funding on the profits
- Capital allowances claimable for plant and machinery, even though used in a dwelling house (this is instead of the 10% wear and tear allowance); the current £100,000 AIA is therefore available to this "business" although owners may not plan to spend anything like that amount

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

The existing and future requirements:

These are as follows, with the possible changes:

- Commercial letting, which means on a commercial basis and with a view to the realisation of profits.
- Let furnished, so that the tenant is entitled to use the furniture.

- Available for commercial letting to the public as holiday accommodation for at least 140 days in a 12 month period (which is the tax year, unless not let furnished in the preceding tax year in which case the period is the 12 months from the first letting; or where not let furnished in the next tax year in which case the period is the 12 months up to cessation). However, the 27 July 2010 consultation document proposes increasing this to 210 days (= 30 weeks) from 2011/12.
- Actually so let for 70 days in the 12 month period. However, the consultation document proposes increasing this to 105 days (= 15 weeks) from 2011/12. That means a UK property is far less likely to qualify.
- Not normally in the same occupation for over 31 consecutive days during a period of seven months in the 12 month period.

Claiming the status

If furnished holiday lets status is available for a non-UK property it may be possible to go back 4 years and claim overpayment relief, provided of course that the overseas tax paid did not effectively eliminate any UK tax on the lettings income or on the gain made on a sale.

If HMRC resists this, on the basis that overpayment relief is not available for earlier years as the tax was calculated in accordance with prevailing practice at the time, you may be able to argue that the relief relates to taxes paid in breach of EU law. That is by reference to HMRC's consideration of the comments of the Court of Appeal concerning prevailing practice in the Franked Investment Income Group Litigation. Specifically, HMRC have confirmed that they will not seek to disallow overpayment relief in such a situation.

But is it a trade anyway?

If you feel that furnished holiday lets status will be lost from 2011/12 (not forgetting that it is an annual test). there is old case law which suggests that where the owner of the property is in occupation of the whole of the premises, then only a relatively modest amount of other services will be sufficient to establish the carrying on of a trade. Otherwise the mere provision of services such as laundry, cleaning and gardening is likely to result in treatment as property income.

A trade should therefore exist where there are, for example, several holiday letting units in a complex which includes the owner's accommodation – typically converted from farm buildings. Facilities could include a laundry room and childrens' play area.

Contributed by Gerry Hart

Lecture P617 (8.12 Minutes)

Capital Gains Tax

Unexpected tax consequences with deferred capital gains

Entrepreneurs' relief has been revamped so that, instead of being a relief which reduced the amount of capital gain otherwise chargeable by four-ninths, it is now a relief that charges capital gains at a newly-created 10% tax rate to be applied to the gain without reduction. Gains not attracting entrepreneurs' relief will be taxed at 28%, to the extent that the basic rate band has already been used.

This article focuses on how these new rules and new rates affect deferred gains where the deferral is associated with an investment being made in a company by the acquisition of QCBs under a corporate reorganisation.

QCB deferrals – pre-6.4.08

Let us consider an example which shows how the entrepreneurs' relief transitional provisions contained in FA 2008, Sch 3 para 7 operate when a deferral ends both before and after 23 June 2010.

Example

In 2007/08, prior to the introduction of entrepreneurs' relief, Oliver, who is a higher rate taxpayer, sold 100% of the issued shares in Model Army Ltd, to New Model Army Ltd.

Oliver's total disposal consideration of £2,000,000 was split as to £500,000 cash and £1,500,000 in the form of New Model Army Ltd loan notes structured to be QCBs and gave rise to a gain of £1,800,000

- £450,000 relating to the cash proceeds - assessable in 2007/08 at 10%
- £1,350,000 assessable when the loan notes are redeemed (TCGA 1992, s 116(10)).

The first redemption of the loan notes took place on 1 May 2010 when Oliver received £500,000 cash and he expects to receive £500,000 on 1 November 2011 and £500,000 on 1 May 2012.

Where the loan notes are encashed on two or more occasions the 'appropriate proportion' of the deferred gain is to be assessed in respect of each such encashment (see FA 2008, Sch 3(7)). In this example, the gain of £1,350,000 deferred from 2007/08 will fall to be assessed as follows:

- 1 May 2010: £450,000 (2010/11)
- 1 November 2010: £450,000 (2010/11)
- 1 May 2011: £450,000 (2011/12)

Encashment – 6.4.08 to 22.6.10

If all or part of the deferment comes to an end on a date from 6 April 2008 to 22 June 2010 inclusive, the entrepreneurs' relief provision may be *deemed* to have been in operation at the time of the exchange.

The effect of this, if the necessary claim is made, is to reduce the deferred gain by four-ninths (subject to the appropriate lifetime cap). Therefore, if at the time of the original exchange and throughout the immediately preceding 12 months, Oliver can show that:

- the company in question had been his 'personal company' (see TCGA 1992, s 169S(3));
- he had been an employee or office holder of that company; and
- the company had been a trading company or the holding company of a trading group;

then he will be treated, when calculating the deferred gain to be assessed post-5 April 2008, but before 23 June 2010, as if he was eligible for entrepreneurs' relief when bringing the deferred gain into charge.

If it was not for this special transitional provision, Oliver could not actually benefit from the relief because the exchange took place before entrepreneurs' relief was introduced.

Subject to applying the lifetime cap, Oliver's capital gain will be reduced by four-ninths and the balance taxed in the normal way, i.e. at 18%.

The first event triggering the end of a period of deferment took place on 1 May 2010 when the lifetime cap was £2 million. Accordingly, the transitional relief operates subject to the then applicable cap at £2 million.

Under the transitional provision, because the loan notes were encashed in tranches, the deferred gain is considered to have been reduced by the level of entrepreneurs' relief available as at the date of the first encashment.

The total deferred gain is reduced by the entrepreneurs' relief calculated, but only the 'appropriate proportion' of the deferred gain as reduced by entrepreneurs' relief is to be assessed in respect of each encashment.

Gain deferred under s 116(10)	£1,350,000
Less transitional entrepreneurs' relief (4/9ths)	£600,000
Reduced deferred gain assessable	£750,000

The 'appropriate proportion' assessable for the period prior 6 April 2010 to 23 June 2010 is one-third of £750,000, i.e. £250,000. This amount is charged at 18% giving rise to a liability of £45,000 (which is still an effective rate of 10%).

Under the transitional provisions, the entrepreneurs' relief cap is determined by the timing of the first relevant disposal, which in this example was on 1 May 2010. The entrepreneurs' relief is set at a level determined by this event for all subsequent encashments. Had Oliver's second and third encashment of the QCBs involved the crystallisation of a capital gain in excess of £2 million, he would not benefit from the post-22 June 2010 increase in the lifetime allowance to £5 million.

Had his first encashment of the loan notes in question taken place on or after 23 June 2010, the £5 million cap would have been applicable throughout.

Encashment – post-22.6.10

Oliver's second loan note encashment also takes place in 2010/11, but post-22 June 2010.The appropriate proportion of the deferred gain assessable in relation to the 1 November 2010 encashment will, as shown above, again be £250,000, but the amount will be charged at 28% (given that Oliver's taxable income exceeds the basic rate band).

Accordingly, £70,000 will be payable in respect of the second encashment. This is a 55.55% increase when compared to the tax payable on the first encashment.

The effective rate of tax on the deferred gain of £450,000 is 15.55% compared with 10%.

Assuming that the 28% rate of capital gains tax is not increased before 1 May 2011, the same rate of tax will arise on the final encashment.

QCB deferrals – 6.4.08 to 22.6.10

To complete the picture, we need to consider the situation where the original deferral took place on or after 6 April 2008 but before 23 June 2010.

The relevant legislation is TCGA 1992, s 169R. Before 23 June 2010, s 169R had effect so that an individual exchanging shares or securities in his 'personal company' on or after 6 April 2008 had the opportunity of claiming entrepreneurs' relief (if the appropriate conditions are met) so as to reduce the gain deferred as discussed earlier under the operation of s 116(10).

It was quite straightforward provided a claim was made. This reduced the deferred gain and allowed the taxpayer to benefit from the reduction in the gain in cash flow terms at the point the QCB was encashed.

Prior to 23 June 2010, the effect was to charge five-ninths of the original gain at 18%, which gave the effective rate of 10% that the legislation was designed to achieve.

However, if this was only a partial disposal, any subsequent disposal on or after 23 June will be charged at an effective rate of 15.55% as above. Where the whole deferred gain falls into charge on or after 23 June 2010, the new 10% rate will apply to the whole of that gain.

Pre- 6 April 2008 gains summary

The key lesson to be learned from the above is that the effective rate of capital gains tax on deferred gains for pre-6 April 2008 gains falling to be assessed under the transitional relief provision varies depending upon the timing of the first occasion where all or part of the gain deferred becomes taxable. The position can be summarised as follows:

First event triggering end of deferment	*Effective rate on deferred gain*
Period 6 April 2008 to 22 June 2010	Gains assessable prior to 22 June 2010 – rate 10% Gains assessable post-22 June 2010 – rate 15.55%
Post-22 June 2010	Gains assessable at rate 10%

From an article by Kevin Slevin, Taxation 25 August 2010

Segesta Limited v Revenue and Customs Comrs

Mr O was the controlling shareholder of a number of companies (the group) which included the appellant company, a subsidiary of the appellant (B), and a company (Z) which held shares in the appellant. B was a professional football club which habitually traded at a loss and regularly needed an injection of funds to continue trading and Mr O frequently lent it money through Z. Mr M, a chartered accountant, was the company secretary of B and Z, and the financial adviser of the group. From May 1996 to December 1999 Mr O was in prison and in his absence the business was run by his wife and son under a power of attorney. On 26 March 1997 Mr O wrote, from prison, to his corporate affairs manager discussing the use of B specifically as a vehicle for obtaining reinvestment relief under the enterprise investment scheme (EIS). While Mr O was in prison Mr M perpetrated a fraud on the business—stealing money from Mr O's gold deposit account and purportedly lending money to B—and he was arrested on 17 April 1998 and imprisoned for three years. One of those frauds consisted of stealing from a joint venture company (J), owned by Mr O and a county council pension fund. The money was introduced into Z, from where it was transferred elsewhere, partly to B. The county council pension fund took vigorous action to recover what had been lost with the result that Mr O personally assumed liability to J for the sums lost and acquired a right to repayment from Z. Mr M's fraudulent activity was first uncovered in April 1998 and the group's financial position was at that time parlous. B, in particular, was running at a deficit and required injections of short term cash. From 20 April 1998 (when £100,000 was injected into B) to August 1999 Mrs O paid substantial sums into B by way of loan, although B also made significant repayments during that period. On 16 December 1999, following Mr O's release from prison, the appellant borrowed £4 million from the bank which was transferred into B's bank account. B then paid the same amount into Mr O's personal bank account; he then transferred £4 million to the appellant to subscribe for 276,494 ordinary £1 shares in the appellant at £15 per share; and the appellant reduced its loan from the bank by £4 million. On 21 December 1999 the appellant issued Mr O 276,494 ordinary £1 shares at £15 per share (ie a total subscription of £4 million). In March 2002 the appellant applied to HMRC under TA 1988 s 306(2) to issue Mr O a certificate enabling him to apply for reinvestment relief in respect of the share subscription. HMRC refused on the grounds that in December 1999 B was indebted to Mr O and repaid that debt on the date of issue of those shares pursuant to an arrangement for or in connection with the acquisition of those shares within the meaning of TCGA 1992 Sch 5B, paras 13(1) and 13(2). The appellant appealed contending that (i) Mr M acted fraudulently or outside his authority in making loans to B on behalf of Mr O, or those loans were made by mistake, and that after Mr M's arrest Mrs O, acting as attorney for her husband, continued

with the same pattern of making loans and thus perpetuated the mistake. Mr O claimed that after a meeting in December 1994 Mr M could have had no doubt that all money should be introduced into B by way of share capital, not loans; (ii) the sums received were due to Mr O by way of restitution and as such they were not repayments of debt, or payments at all within TCGA 1992 Sch 5B, para 13. On that basis the shares by Mr O in the appellant were eligible shares and he was entitled to reinvestment relief; (iii) both repayments in TCGA 1992 Sch 5B, para 13(2)(b) and payments in para 13(2)(i) did not encompass the case where B had acquired no beneficial interest in the money it received as a consequence of wrongdoing, breach of authority or mistake; (iv) a purposive approach should be adopted and the tribunal could conclude that relief should be disallowed only to the extent of the value received; and (v) each share had been acquired for its subscription price of £15, and that on that basis an apportionment should be possible.

The tribunal considered that TCGA 1992 Sch 5B, para 13(2)(b) was confined to payments of debt pursuant to certain and express agreement, such as debts incurred by way of loan, and did not extend to a mere payment of money that had fallen due absent such certain or express agreement, including moneys that a trustee was liable to pay to a beneficiary on account of the beneficiary's own beneficial ownership of those moneys. There was a difference between a case where an action was taken by a beneficiary against a trustee for breach of trust, where the money sought to be recovered was that of the beneficiary before the breach, and a case where a claim to money not previously belonging to a person was made on the basis of receipt of that money in breach of duty or by reason of fraud. In the former case the money was regarded as in the possession of the trustee for the benefit of the beneficiary; in the latter case title was established only by the action itself. Where the money was the beneficiary's own money, the obligation of the trustee to pay that money to the beneficiary could not be regarded as a debt for the purpose of para 13(2)(b). Paragraph 13(2)(b) did not refer to a debt, whether legal or equitable, that arose purely because a legal obligation to pay had arisen.

The tribunal considered that in order to qualify for reinvestment relief, the company must have assisted the share acquisition by using its own resources, whether in the form of cash or a benefit to the individual. The aim of TCGA 1992 Sch 5B, para 13 was to prevent the company's own cash or resources being used either to provide the cash for the share subscription or to provide some corresponding advantage to the subscriber for the shares such that the company itself did not fully benefit from the injection of capital. That involved the concept of value being received—a term that was exhaustively defined by para 13(2). Although the actual receipt of value was not itself a condition, the use of that phrase was indicative of the scope and intendment of para 13(2). It was clear that it was not necessary in all cases for value as such to have passed from the company to the individual. Thus, the mere making of a loan or advance was treated as the receipt of value notwithstanding that that would be accompanied by a right to receive repayment and would, therefore, not necessarily transfer value. But it would involve the company assisting the share subscription out of its own resources. The test was not a balance sheet test, as the mere repayment of a loan would not normally result in a reduction of the assets or value of the company in question. But such a repayment would constitute assistance out of the resources of the company. Accordingly where B had no beneficial interest in amounts paid to it, ostensibly by way of loan, the mere return of equivalent amounts did not constitute a payment or repayment within either TCGA 1992 Sch 5B, para 13(2)(b) or 13(2)(i), as such a return did not involve any transfer out of the resources of the company.

Applying that construction of para 13 to the facts of the case, the tribunal found that (i) for the period up to Mr O's imprisonment on 23 May 1996, Mr M's authority to make loans to B was not limited by any instruction from Mr O or by Mr M's own knowledge. On the facts Mr M was not instructed by Mr O at the time of the December 1994 meeting, or thereafter up to early 1997, to introduce funds into B only by way of share subscription into B or the appellant. Money introduced into B by way of loan during that period represented B's valid debts owed to Mr O. To the extent those debts were repaid on 16 December 1999, those repayments fell within TCGA 1992 Sch 5B, para 13(2)(b); (ii) from 23 May 1996 to Mr M's arrest on 17 April 1998, Mr M stole money from Mr O's gold account. At that stage Mr M was aware that money should be introduced into B or the appellant by way of share subscription. Mr O had a right of restitution in respect of all money derived from that account that were purported to have been lent to B. The recovery of those amounts on 16 December 1999 amounted to neither the repayment of a debt within the meaning of para 13(2)(b) nor to a payment within para 13(2)(i); (iii) from 26 March 1997, which was the earliest date

there was evidence of Mr O's instructions to Mr M to put money into B by way of subscriptions for shares, Mr M's authority to make loans to B was curtailed. After that date such amounts were recoverable by Mr O by way of restitution and were neither repayments of debt within para 13(2)(b) or payments within para 13(2)(i); (iv) from 18 April 1998, payments by Mrs O on Mr O's behalf to B by way of loan were valid loans. The repayment of those loans on 16 December 1999 fell within para 13(2)(b); and (v) the amount owed by Z to Mr O that arose as a result of his assuming Z's debt to J was a debt of Z. The repayment of that debt on 16 December 1999, through payment by B directed by Z to be made to Mr O, was the repayment of a debt within para 13(2)(b). Accordingly part of the amount of £4 million that was paid to Mr O by B on 16 December 1999 was a repayment of debts due to Mr O within TCGA 1992, Sch 5B para 13(2)(b). Mr O was therefore regarded as having received value from the appellant, on the basis that B was a company connected with the appellant. A similar analysis applied in respect of the debt treated as repaid by Z to Mr O. Accordingly, the effect of para 13(1)(a) was that the shares in question subscribed for by Mr O were treated as never having been eligible shares.

The tribunal considered that TCGA 1992 Sch 5B, para 13(1) referred to "any value" having been received, and operated wholly by reference to a comparison of the time that any value (as defined) was received with the date of the issue of the shares. There was no scope for any apportionment by reference to the extent of the value received. In the instant case there was only one subscription for and issue of shares. All the shares comprised in that single issue were "the" shares to which para 13(2)(b) referred. The repayment of the loans, although representing only part of the subscription price, was wholly for or in connection with the single acquisition of the shares subscribed for by Mr O. Furthermore, the legislation clearly envisaged a subscription for, and issue of, a number of shares, and it would go against the ordinary and well-established accepted meaning of those terms to seek to treat each share as having been individually subscribed for or issued. There was a single subscription and issue of shares, and the repayment of the loans was associated with the shares comprised in that subscription and issue. All of the shares therefore had to be treated as never having been eligible shares. It followed that the appeal would be dismissed.

Appeal dismissed.

Acquiring property interests piecemeal

The following question and answers appeared in Taxation Forum in September 2010.

"Our client already owns one half of a family holiday property, acquired as two separate quarters on different dates and at different prices. No only or main private residence elections have been made. The holiday property is one big house and is now very valuable.

He now intends to buy a third quarter interest in the holiday property from his sister-in-law. If he does, can he elect that this is to be his main residence for a couple of weeks, then switch back to the flat to take three years' growth on that quarter out of capital gains tax?

Could he put the first two quarters into the issue and elect for them similarly?"

Reply from Taxplanet

There are three separate issues to consider here:

1. Can the holiday property can qualify as a residence within the meaning of TCGA 1992, s 222?
2. If it can what is the time limit for making an election for it to be treated as the main residence?
3. How the relief is calculated?

Qualifying residence

It is not essential for the whole of a dwelling to be owned, and different interests can be owned at different times. The most common situation where a jointly owned dwelling might qualify as a main residence is where a property is owned jointly by husband and wife.

The computational aspects of acquiring different interests at different times are recognised by s 222(7), which notes that the 'period of ownership' is measured from the first acquisition taken into account in computing gains to which the private residence relief applies.

'Residence' is not defined in s 222, or anywhere else in the Taxes Acts, and therefore the word must take on its ordinary meaning in its context.

A point for debate here, and which HMRC may want to contest, is if a property which is a holiday home is used by several different family members throughout the year and no one has occupation to the exclusion of all the others can the property be said to be the 'residence' of any of them?

The matter could depend upon the degree and quality of occupation. Whether the client can control who occupies the property and whether he can enjoy occupation to the exclusion of all others except with his permission is likely to be important in the writer's view.

Time limit

Assuming that the property can qualify as a residence, the client will have a period of two years from first using the property as a residence in which to elect to treat the property as his main residence (s 222(5)(a)).

If he first started using the property as a residence immediately after acquiring his first interest in the property the time limit will expire two years from that date. If he did not use the residence for the first time until a later date the two year time limit will run from that later date.

So if the client could not dictate who occupied the property until he acquired a half or a three-quarters share in the property and first furnished the property exclusively with his possessions after acquiring a majority share it might be possible to argue that the property only acquired the quality of a residence from that later date, if that is to his advantage in terms of making a timely election.

If the client is out of time for an election the question of which of his two residences qualifies as his main residence becomes a question of fact.

Varying the election

If the property can qualify as a residence and an election can be made within time then there is an opportunity to vary the election at any time thereafter (s 222(5)(b)) and for any reason.

Electing for the 'holiday home' to be treated as the main residence for a period of as little as two weeks would result in the last 36 months of ownership being treated as a period of occupation even if the owner was not physically present in the property for all that time (s 223(1)).

As noted above, for the purposes of calculating the period of ownership mentioned in s 223, s 222(7) provides that the period should begin from when the claimant acquires, in this case, his first quarter share in the property.

The base cost of the property is calculated by adding together the costs of acquiring the various fractional interests in the property at various times (TCGA 1992, s 38(1)(a)), but as already noted the gain attributed to each fractional share, and the private residence relief that might apply to each part, is not calculated separately for each fractional share acquired.

Reply from DH Young, BKL Tax

In this case, the client first occupied the property as a holiday home when he acquired the first quarter share (or indeed perhaps even before then if it was already owned by the family).

The acquisition of further interests does not alter the fact that it was already a residence of his. The time limit for making an election would be two years from the beginning of the period when it was first used as a residence of his and this deadline, one assumes, has expired.

The acquisition of the third quarter interest does not therefore create the opportunity to make an election now. As matters stand the question of which of his residences is his main residence will be determined as a matter of fact and, of course, is likely to be his city centre flat.

There are two ways in which it might be possible to change the position. If the holiday home were to be let exclusively to someone other than the client, for a period of time, and then subsequently became available to him again at the end of the let, then the opportunity to make an election arises when the property returns to his use.

However, the election would only apply from that time forward, not retrospectively, but at least it would secure only or main residence relief on the last three years of ownership (and perhaps a bit of letting exemption if the property is owned for more than three years going forward).

Alternatively, if the client occupies a third residence (even if this is only a leased property) again it would be possible to make an election from that time forward.

Once the election has been validly made it can be varied to any of the properties as appropriate.

Taxation Forum, 8 September 2010

Rollover relief on incorporation

The following question and answers appeared in Taxation Forum in September 2010.

"My client has a portfolio of 15 properties which are let on shorthold tenancies. A firm of letting agents have been appointed to act on behalf of my client to vet new tenants and deal with rent collection.

The client handles other matters relating to the properties personally, such as either carrying out repairs and maintenance from time to time, or else arranging for others to do the work necessary which on average takes about one or two days per week on this work.

He wishes to transfer the properties to a newly-formed company and it is crucial that capital gains tax roll over relief is available under TCGA 1992, s 162.

Can readers advise on the chances of this relief being allowed? "

Reply from DH Young, BKL Tax

TCGA 1992, s 162 applies where a person who is not a company transfers to a company a *business* as a going concern… wholly or partly in exchange for shares.

So does the clinet have a *business*?

ITTOIA 2005, s 268 charges tax on 'the profits of a property business'. So can your client rely on s 268: a 'property business' is by definition a 'business'?

Unfortunately, HMRC do not accept that the position is quite so clear cut, although, as so often seems to be the case, their guidance is singularly unhelpful.

In the department's view, an activity of renting out property might or might not be a business for the purposes of s 162, depending on the precise facts and following from dicta in some rather old tax cases.

The client has a portfolio of 15 properties, all on shorthold tenancies, which presumably implies a regular change of tenants. He spends a significant amount of time (one to two days a week) managing this portfolio and carrying out other work related to the properties.

This seems to me to go beyond the mere passive receipt of rents and is closer to an actively managed business. I see no reason why s 162 should not apply in these circumstances.

My experience is that HMRC will accept this position where there are a number of properties involved and where there are more frequent changes of tenants which inevitably requires more active management.

Of course, the Act also requires that the whole assets of the business are transferred which means that all of the client's rental properties must be transferred to the company without exception.

Taxation Forum, 1 September 2010

Three properties

The following question and answers appeared in Taxation Forum in September 2010.

“We have a client who has a problem concerning capital gains tax relating to a main residence.

Property A was purchased in May 1999, property B was purchased in June 1999, and property C in May 2002.

Property A was occupied as a main residence until it was sold in August 2005. Prior to that, an election under TCGA 1992, s 222 was made for property B to be regarded as the main residence with effect from 1 May 2002.

No capital gains tax was paid on the disposal of property A as it was also let for a period of time and the taxable part of the gain relating to the non-main residence period was covered by the residential lettings exemption.

Both properties B and C have increased in value by just over £2 million each and the capital gains on either would be very similar as their original costs were within £100,000 of each other.

The facts are that property C was actually occupied within a short time of purchase in May 2002 and property B has been let more or less throughout the period since then.

Our client wants to dispose of one of the properties, preferably C, but is worried that the election will take precedence over the facts of occupation. We are not sure whether we can use the period of occupation as a fact in determining property C as a main residence or whether this is superseded by the election that has been made. Any guidance from readers would be helpful.”

Reply from N.K.

An answer to this query can be found under HMRC’s *Capital Gains Manual* at CG64485 (‘Two or more residences: Right of nomination’), which states:

‘If an individual has two or more residences within TCGA 1992, s 222, he or she has the right under TCGA 1992, s 222(5) to nominate which is to be treated as the main residence for any period and so will attract relief for the period …’

> ‘TCGA 1992, s 222(5) gives an individual the right to choose which of his or her two or more residences is to be treated as the main residence for only or main residence relief purposes. It therefore follows that a dwelling house must be in use as a residence of that individual before it can be validly nominated.
>
> ‘In certain circumstances, the legislation treats a dwelling house which is not a residence of an individual as if it was their residence for a particular period (see CG64477). This may result in an individual having more than one residence within s 222 and in these circumstances the right of nomination applies in the same way.
>
> ‘When nominating which residence is to be treated as the main residence, an individual is not obliged to nominate the residence which is factually his or her main residence; they may nominate whichever residence they choose.’

This means that for tax purposes the record for main residence is set according to the property which has been nominated and, as stated, does not depend on actual main residence occupancy.

Therefore, from what we have been told and with reference to CG64485, the election dated 1 May 2002 at present takes precedence, and so property B holds the main residence status.

However, looking at CG64495 (‘Two or more residences: Time limit for nominating’), with regards to the two years from the date of a change rule under TCGA 1992, s 222(5)(a), this states:

> ‘… Where a dwelling house is acquired, the date on which there is a new combination of residences will not necessarily be the date of acquisition, it will be the date on which the dwelling house was first used as a residence. Similarly, where an individual ceases to use a dwelling house as a residence, the date on which there is a new combination of residences will be the date on which the dwelling house is no longer used as a residence, it will not necessarily be the date on which that dwelling house is disposed of.’

There is therefore the possibility of making a temporary election as per CG64510 (‘Two or more residences: Variation of a notice’). This states that ‘a notice given under TCGA 1992, s 222(5) can

be varied by a further notice at any time. The further notice can be backdated to be effective from up to two years from the date that it was given.

> 'A variation will often be made when a disposal of a residence is in prospect or the disposal has already been made and the individual making the disposal wishes to secure the final period exemption …
>
> 'For example, where an individual with two residences validly nominates house A, they may vary that nomination to house B at any time. The variation can then be varied back to house A within a short space of time. This will enable the individual to obtain the benefit of the final period exemption on house B with a loss of only a small proportion of relief of on house A.'

Taxation, 22 September 2010

New-style entrepreneurs' relief

Overview

This relief, available as always on qualifying business disposals, serves to reduce the CGT rate to 10% on the first £5 million of gains in certain circumstances (£2 million if the disposal was between 6 April 2010 and 22 June 2010; £1 million if the disposal was before 6 April 2010). It is now therefore worth a maximum of £900,000 (£5 million taxed at 10% rather than 28%) and as such has an ever-increasing role to play in mitigating CGT.

It is clearly even more important to ensure wherever possible that a disposal does qualify for the relief. The creation of an associated disposal, where feasible, can turn a CGT liability on an isolated property sale from 28% to 10%.

But the dramatic increase in relief is not all good news, as at the same time the rules have been changed where CGT deferral relief is claimed.

Deferred gains

The position has changed for gains charged to tax from 23 June 2010 and is as follows depending on the date of the original event. It assumes the taxpayer is a 40% or 50% taxpayer after adding the gain to income for this purpose.

The new rules mean that in tax terms deferral relief on a disposal from 23 June 2010 which qualifies for entrepreneurs' relief is not an attractive proposition. However, the cash-flow aspect must be taken into account, as must the likelihood of the shareholder still owning the shares on the reinvestment on death where of course no CGT is payable and therefore CGT deferral is attractive. It should also be noted that if claiming entrepreneurs' relief it is not possible to also claim deferral relief on the same disposal. But any claim made for entrepreneurs' relief can be withdrawn within the usual deadline which is the 31 January next after the 31 January following the year of the disposal (= 1 year 10 months after the end of the tax year of disposal).

Here are several examples:

1. Disposal on which gain deferred via EIS investment is before 6 April 2008

If first chargeable event for the EIS shares is between 6 April 2008 and 22 June 2010, the claim to entrepreneurs' relief on the first event reduces the remaining postponed gain by 4/9ths up to the lifetime limit applying on the first disposal. The reduced deferred gain is then taxed at 28% for gains arising from 22 June 2010. This gives an effective CGT rate on the deferred gain of 5/9 x 28% = 15.55% instead of the 10% which applied on a disposal before 23 June 2010. Increase is 55.5%.

If first chargeable event for the EIS shares is after 22 June 2010, a claim can be made for entrepreneurs' relief under transitional rules for gains arising from 22 June 2010, with the deferred gain taxed at 10%.

2. Disposal where gain deferred via EIS is between 6 April 2008 and 22 June 2010

Claim to entrepreneurs' relief on the original disposal reduces the remaining postponed gain by 4/9ths up to the lifetime limit applying then. The reduced deferred gain is then taxed at 28% for gains arising from 22 June 2010. This again gives an effective CGT rate on the deferred gain of 15.55%.

3. Disposal on which gain deferred via EIS investment is after 22 June 2010

Choice of either:

- Claim entrepreneurs' relief with no EIS deferral relief, and pay CGT at 10% on crystallised gain; or
- No claim for entrepreneurs' relief, claim EIS deferral relief and pay CGT at 28% when the deferred gain is brought into charge.

Example

Ms A was a director of A Ltd and owned 75% of the shares and votes. She sold her shares to the company on 1 June 2006 for £500,000 with CGT clearance obtained. She started the company in 1980.

Ms A decided to defer her CGT liability by reinvesting £500,000 on 1 December 2006 in a new subscription for shares in a company B Ltd which met the EIS requirements. She does not work for B Ltd.

On 1 January 2010 she sold her shares in B Ltd for £600,000, so the old rules apply on both disposals:

CGT deferral on sale of shares in A Ltd

	£
Proceeds	500,000
Value at 31/3/82 (say)	(30,000)
Indexation @ 104.7%	(31,410)
Gain deferred	438,590

Gain on sale of shares in B Ltd

Proceeds	600,000
Cost	(500,000)
Gain	100,000
Deferred gain brought into charge	438,590*
Total gains	538,590
Entrepreneurs' relief 4/9 x 438,590	(194,929)
Chargeable gain	343,662
CGT @ 18%	61,859

* Effective CGT on deferred gain is £438,590 @ 10% = £43,859

Sale of the shares in B Ltd was not until after 22 June 2010

Gain on sale of shares in B Ltd

Gain as above	100,000
CGT @ 28%	28,000
Deferred gain brought into charge	438,590
CGT @ 10%	43,859

Total CGT = £71,859

The only extra CGT is on the B Ltd shares to reflect the rate increase from 18% to 28%.

Deferred gain after 5 April 2008 and B Ltd shares sold after 22 June 2010

The position would be different on both sales:

Gain on sale of shares in A Ltd

	£
Proceeds	500,000
Value at 31/3/82 (say)	(30,000)
Gain	470,000
Entrepreneurs' relief 4/9	(208,889)
gain deferred after ER	261,111

Gain on sale of shares in B Ltd

Gain as above	100,000
Deferred gain brought into charge	261,111
	361,111
CGT @ 28%	101,111

The extra CGT reflects:

(a) the loss of indexation allowance;

(b) the increase in the CGT rate on the deferred gain to effectively 15.55%;

(c) the increase in the CGT rate on B Ltd shares from 18% to 28%.

Gain on the sale of shares in A Ltd had not arisen until after 22 June 2010

The position would be that Ms A can choose either:

1. On sale of A Ltd shares, pay CGT @ 10% on £470,000 = £47,000; on sale of B Ltd shares pay CGT @ 28% on £100,000 = £28,000. Total CGT = £75,000; OR
2. On sale of shares in A Ltd shares, defer gain of £470,000; on sale of B Ltd shares pay CGT @ 28% on £470,000 + £100,000 = 28% on £570,000 = £159,600

Contributed by Gerry Hart

Lecture P618 (11.36 Minutes)

Earn Outs – Bad News Returns

Shares exchanged for QCBs

The tax position on this form of CGT deferral depends on a number of factors as shown below:

date of share-for-QCB exchange	**date of first disposal or part-disposal of QCB**	**position on gains** **charged from 23/6/10**
pre-6/4/08	6/4/08 to 22/6/10	claim to ER on first part-disposal reduces remaining held-over gain by 4/9ths up to lifetime limit at time of first disposal; reduced held-over gain taxed at 28%
pre-6/4/08	after 22/6/10	claim can be made for ER under transitional rules with CGT at 10%
6/4/08 to 22/6/10	at any time	claim to ER on exchange reduces held-over gain by 4/9ths up to lifetime limit; reduced held-over gain taxed at 28%
from 23/6/10	at any time	choose (a) crystallise gain on shares, claim ER and pay CGT at 10%, or (b) hold-over gain under normal rules and pay CGT at 28% when QCB disposed of (10% if all conditions met by reference to the QCB company)

For a share-for-QCB exchange from 23 June 2010, therefore, the rules are the same as have always applied for non-QCBs on redemption. Then the test is the qualifying position in the acquirer company and it is unlikely that the holder will own 5% of the share capital. However, an election can be made to have the gain charged on the exchange in which case it does qualify for entrepreneurs' relief if the vendor's position allows.

The result

The result of the changes is that accepting loan notes in exchange on a company take-over from 23 June 2010 is generally not attractive from a tax viewpoint.

Company reorganisation via share exchange – Section 169Q

This arrangement can be a form of earn-out, whereby further consideration is received by reference to any increase in the value of the shares acquired. On a company reorganisation there is no disposal of the original shares and instead the new holding is treated as the same asset under Section 127 TCGA1992. That may result in no entrepreneurs' relief on a subsequent disposal of the new holding, where the shareholder does not work for the company and/or does not own at least 5%. That can be avoided by making an election under Section 169Q so that the original shares are treated as disposed of at the time of the reorganization, by way of disapplying Section 127. The election time-limit is 31 January next after the 31 January following the end of the tax year of the reorganisation (= 1 year 10 months after the end of the tax year of the reorganisation).

Where the shareholder does meet all of the requirements for entrepreneurs' relief in respect of both the old holding and the new holding, the ownership period of the latter includes that of the former as confirmed by HMRC.

Sale of shares where exchange or earn-out involved

1. Where the consideration is via shares and/or loan notes in the acquiring company, the CGT can usually be deferred until the new shares are sold or the loan notes are redeemed.
2. Where part of the sale proceeds are determined as an earn-out, the initial CGT charge is on any cash consideration plus the market value of the expected receipts. The gain qualifies for entrepreneurs' relief if the usual conditions are met, but the gain calculated on the actual earn-out receipts does not as it is a gain on a separate asset (viz. a *chose in action*) and CGT is charged at 28% assuming the taxpayer is not a basic rate taxpayer with the gain added. This is under *Marren v Ingles*. Clearly the increase in CGT from 18% to 28% has made the potential position worse and the solution is to value the earn-out as high as possible so that there is little or no prospect of a gain arising on the disposal of the chose in action. It is also a case of ordinarily seeking as much cash up front as possible so that the earn-out aspect is not a major issue.
3. If a loss arises on the later disposal an election can be made under Section 279 TCGA1992 to treat the loss as arising in an earlier year subject to the following conditions:
   - loss arises on a disposal of a right to unascertainable deferred consideration
   - person must not have acquired the right second-hand
   - disposal of the original asset for which the right was received must have given rise to a chargeable gain
   - person must have had a CGT liability for tax year in which that disposal was made.
4. The original gain may relate to part-disposals in different tax years. In that case the Section 279 election treats the loss as though it arose as under:
   - either in the tax year the right was received, if there was a CGT liability then;
   - or in the earliest tax year following that in which the right was received, where a gain arose on disposal of the original asset and there was a CGT liability
5. Any part of the loss which cannot be utilised by carry back in this way can be carried forward in the usual way. It can alternatively be set against gains of an intervening tax year (a year between that in which the loss is treated as arising and the tax year when it actually arose) provided the person concerned realised a gain on a disposal of the original asset and had a CGT liability in that intervening year.

Example

Mr A sells shares on 1 October 2010 for £450,000 plus cash earn-out valued at £300,000. The base cost of the shares, which were acquired in 1999, is nil. No previous entrepreneurs' relief claimed by Mr A, who owns all of the issued share capital and has always worked for the company.

CGT charged on gain of £750,000 for the shares, taxed at 10%

If earn-out proves to be £400,000, CGT charged on gain of £100,000 for the chose in action. No entrepreneurs' relief.

If earn-out proves to be £100,000 there is a CGT loss of £200,000 for the chose in action. This loss can be carried back and set against the gain of £750,000 (entrepreneurs' relief is then given on overall gain of £550,000 which is then taxed at 10%).

Contributed by Gerry Hart

Lecture P619 (9.27 Minutes)

Private residence relief – what is use as a residence?

Background

One of the many requirements to qualify for the invaluable CGT private residence relief is that the property must be used as a **residence**. This is indeed of fundamental importance so it is frustrating that there is no statutory definition.

The Oxford Shorter Dictionary refers to it being a person's "permanent or usual abode". There is however a good deal of case law, and the recent case of *Paul Flavell v HMRC TC00642* may provide a clue as to how long one needs to reside at a property for it to be that person's residence.

Case law

Paragraph CG64441 of the *Capital Gains Manual* says the test is one of quality of occupation rather than quantity. In *Moore v Thompson (1986) STC 170* Justice Millett referred to the Commissioners *"being alive to the fact that even occasional and short residence in a place can make it a residence, but the question is one of fact and degree for the Commissioners"*

In *Goodwin v Curtis (1998) STC 475* the problem was not uncommon, in that it was clear that the owner of the property started to occupy it (albeit full-time) without intending it to be on a permanent basis. That important case shows how not to arrange matters. The clear intention to leave the property was the only matter that needed to be considered for it to be held that the taxpayer had not occupied the property as a residence, so the fact that he occupied the property for some five weeks on an exclusive basis did not have to be considered. Comments made include:

- *"Temporary occupation at an address does not make a man resident there. The question whether the occupation is sufficient to make him resident is one of fact and degree for the commissioners to decide".*
- *"Residence in the property must show some degree of permanence, some degree of continuity or some expectation of continuity".*

An interesting case, as already mentioned, is *Paul Flavell v HMRC TC00642*. Although the taxpayer lost, this was because the Tribunal decided that there was no evidence to show that the taxpayer had ever lived in the property. They said *"if the taxpayer had been able to demonstrate that he had occupied the property from January to August 2001 we would have been minded to hold that such occupation would have amounted to residence for the purposes of Section 222 TCGA1992".*

That comment might suggest that although it may well still be about quality rather than quantity, living all the time at a property for at least 7 months will ensure relief in the absence of any other factors. It may be of course that a shorter period will suffice, but at least the *Flavell* case provides some judicial guidance.

Talking of quality of occupation, in *Frost v Feltham (1981) STC 115*, relating to mortgage interest relief but still considering whether a property was the main residence. It was held that even spending only several days a month living at the property can be sufficient.

The tests to establish the main residence

Another issue is the evidence needed to establish use as a residence, as the onus of proof is with the claimant. The personal and family ties need to be considered, by reference to the following, although of course this is no guarantee of success in itself:

- registration with doctor or dentist
- where majority of personal possessions kept
- registration to vote
- membership of clubs and societies
- the normal postal address
- what the owner regards as the main residence
- time split
- where spouse and dependants live
- from which residence children attend school
- where time spent with family

Contributed by Gerry Hart

Lecture P620 (8.34 Minutes)

Inheritance Tax and Trusts

Deed of rectification

The claimant was the husband of the dec'd, C. The first defendant was C's brother and the second and third defendants were C's only children. The claimant and the first defendant were the two executors of C's estate, which was worth some £1.7m. Under the terms of C's will as executed, the claimant was to receive £10,000 and farmland, whilst the residue passed to the second and third defendants. The assets which were left to the claimant were meant to pass to him free from any liability for inheritance tax; and the burden of the tax chargeable to the estate fell upon the children as residuary beneficiaries. The estate's accountants, having reviewed the tax implications under the will as executed, suggested drawing up a deed of variation by which the claimant was to be treated as the residuary beneficiary so that the surviving spouse exemption should apply to the whole estate, with the exception of that part of the share portfolio which was to be given to the children and the farmland. Under the deed of variation, the claimant was to exchange the farmland for part of the share portfolio. The deed of variation was completed. However, it was defective in a number of respects and, in the event, the Revenue and Customs Commissioners wrote to the claimant's solicitor enclosing a calculation showing some £33,000 to be due by way of additional inheritance tax. Given that, under the deed of variation, the claimant was to be treated as the residuary beneficiary, it fell to him to bear the incidence of the inheritance tax. The parties sought to correct the mistake by executing a deed of rectification to the effect that the claimant would not be liable to pay inheritance tax. There was evidence, including the claimant's witness statement and documents exhibited thereto, which showed that the change to be effected by the deed was that the land, which passed to the claimant under the will, should be exchanged for an equivalent part of the share portfolio, and that the remainder of that portfolio was to be the only chargeable part of the estate, so that all other assets, except for the tax-exempt land, should pass to the claimant. The Revenue refused to accept the efficacy of the deed of rectification for tax purposes. The claimant applied to the court seeking approval of the deed of rectification. The defendants did not contest the claim.

The claimant submitted, inter alia, that rectification should be granted as the conditions for rectification had been satisfied and there was no suggestion in any of the contemporaneous documents or otherwise that he was intended to assume any liability for inheritance tax.

The court ruled:

> A mere misapprehension as to the tax consequences of executing a particular document would not justify an order for its rectification. The specific intention of the parties as to how the fiscal objective was to be achieved had to be shown if the court was to order rectification. The court would order the rectification of a document only if it was satisfied by cogent evidence that: (i) the document did not give effect to the true agreement or arrangement between the parties, and (ii) there was an issue, capable of being contested, between the parties; it being irrelevant, first, that rectification of the document was sought or consented to by all of them; and, secondly, that rectification was desired because it had beneficial fiscal consequences. Conversely, the court would not order rectification of a document if the parties' rights would be unaffected, and if the only effect of the order would be to secure a fiscal benefit for one or more of them. It was firmly established that the fact that the parties intended to use a particular form of words in the mistaken belief that it was achieving their common intention did not prevent the court from giving effect to their true intention. It would be contrary both to principle and to authority to confine the distinction between a mistake as to the meaning or effect of a document, which might be amenable to rectification, and one as to its consequences, which was not, to cases involving voluntary transactions. It applied to all claims for rectification. The relevance of the distinction did not depend upon the nature of the document which it was sought to rectify. Rather, it was a limitation which was inherent in the nature of the equitable remedy itself (see [15]–[16], [17] of the judgment).

In the instant case, the claim for rectification would be upheld. The deed of variation had failed to give effect to the true agreement of the parties. On the evidence, the claimant had established, to the required standard of proof, that the true intention of the parties to the deed of variation had not in any way been to alter the incidence of the burden of the inheritance tax chargeable upon the

deceased's estate but merely to reduce the amount of tax payable to the Revenue. Under the terms of the will as executed, the assets which were left to the claimant passed to him free from any liability for inheritance tax; and the burden of the tax chargeable to the estate fell upon the children as residuary beneficiaries. Since the whole genesis and objective of the deed of variation was to mitigate the amount of inheritance tax chargeable upon the estate, it would have made no economic sense to relieve the children of any part of their pre-existing liability for tax in circumstances where doing so would have resulted in an additional charge to tax (because of the effect of grossing-up) which would fall upon their father. The claimant had demonstrated a specific common intention as to how the parties' fiscal objectives were to be achieved; and he had established that, owing to a mistake in the way in which that intention was expressed in the deed of variation, effect had not been given to that intention. Underlying the parties' adoption of the deed of variation was the common intention, unarticulated and unexpressed, that the claimant should receive his entitlement under C's will, as varied, free from all liability for inheritance tax, thereby replicating the position under the will as executed. There had never been any intention to vary the burden of, or the incidence of the parties' liability for, inheritance tax. To the extent that the deed of variation had this effect, then it had been executed under a relevant mistake, because it had failed to give effect to the parties' true intention (see [19], [20], [23] of the judgment).

Ashcroft v Barnsdale and ors [2010] EWHC 1948 (Ch)

Domicile and Inheritance Tax

HMRC has made changes to the circumstances in which it will consider an individual's domicile and decide whether to make a determination of inheritance tax based on that.

This Revenue & Customs Brief details changes to the circumstances in which HM Revenue & Customs (HMRC) will consider an individual's domicile and decide whether to make a determination of Inheritance Tax based on that. These changes are being made because in HMRC experience the existing guidelines were not working well for the customer and HMRC. In future, by adopting a wider risk-based approach HMRC will ensure that resources are deployed in the most cost effective way.

Revenue & Customs Brief 17/2009 issued on 25 March 2009 described changes to procedures following the changes to the remittance basis rules and the residence rules made by the FA 2008. The relevant sections are in Appendix A below and these are superseded by the revised guidance below.

Revised guidance

The revised guidance applies to dispositions made after the issue of this Revenue & Customs Brief.

In future HMRC will consider opening an enquiry where domicile could be an issue, or making a determination of Inheritance Tax in such cases, only where there is a significant risk of loss of UK tax.

The significance of the risk will be assessed by HMRC using a wide range of factors. The factors will depend very much on the individual case but will include, for example—

- a review of the information available to HMRC about the individual on HMRC databases
- whether there is a significant amount of tax (all taxes and duties not just Inheritance Tax) at risk

HMRC does not consider it appropriate to state an amount of tax that would be considered significant, as the amount of tax at stake is only one factor. It should be borne in mind that HMRC will take into account the potential costs involved in pursuing an enquiry, and also those of potential litigation should the enquiry not result in agreement between HMRC and the individual; clearly such costs can be substantial.

Where HMRC does open an Inheritance Tax enquiry in any of these cases, it will keep the factors in view and may stop the enquiry at any stage if it considers the continuation of the enquiry is not cost effective. The outcome of such an enquiry may be that HMRC does not consider it appropriate to make a determination of the Inheritance Tax.

Individuals should also bear in mind that enquiries into domicile involve a detailed inquiry into all of the relevant facts and HMRC is likely to require considerable personal information and extensive documentary evidence about the taxpayer and the taxpayer's close family.

Appendix A: Extract from Revenue & Customs Brief 17/09 superseded by Revenue & Customs Brief 34/2010 issued on 24 August 2010.

"Where an individual who is not domiciled in the UK settles non-UK assets into a non-UK resident trust then assets in that trust will not be subject to Inheritance Tax. Following the release of the new HMRC guidance on domicile most settlors should now be able to decide for themselves whether or not they are UK domiciled."

"An individual setting up a non-resident trust who, having taken account of the new HMRC guidance, considers they are non-UK domiciled is not obliged to submit an Inheritance Tax account to HMRC. If the settlor is non-UK domiciled then no Inheritance Tax is due. But if an Inheritance Tax account is submitted in these circumstances, HMRC will continue its existing practice and only open an enquiry into that return if the amounts of Inheritance Tax at stake make such an enquiry cost effective to carry out. At present that limit is £10,000."

R&C v Brander (Executor of the Will of the late Fourth Earl of Balfour)

In 1968, the deceased inherited a liferent interest over a traditional Scottish landed estate (the estate). In 2002, he applied under s 47 of the Entail Amendment (Scotland) Act 1848 to end his liferent and obtained a declaration that he was the fee simple proprietor of the heritable estate. The deceased then entered into a partnership (the partnership) with his nephew and heir, B. The estate's heritable properties were included in the partnership capital. The partnership business was estate management and farming. The deceased died in 2003. B was his executor. The Revenue and Customs Commissioners (the Revenue) made a determination that the deceased's interest in the partnership was not "relevant business property" within the meaning of s 105(1)(a) of the IHTA 1984 and therefore did not attract business property relief (BPR) under s 104 of the Act because the activities carried on at the estate consisted wholly or mainly of the making or holding of investments within s 105(3) of the Act; alternatively, the estate management and farming activities were not managed by the deceased as his single composite business immediately prior to the formation of the partnership and were not replaced by the partnership according for the purposes of s 107b of the Act. The executor appealed to the first-tier tribunal (the tribunal). The tribunal found, inter alia, that: (i) the provisions of the will under which the deceased had inherited his interest in the estate (the will) had directed the trustees to grant the deceased the powers equivalent to those of a proper liferenter; (ii) that the deceased's business activities were a single composite business; (iii) that the deceased's business enterprise had been carried on for gain; and (iv) that the business was not mainly one of holding investments. Accordingly, the tribunal allowed the appeal. The Revenue appealed to the Upper Tribunal.

The issues which fell to be determined included: (i) the status of the deceased's liferent, having regard to the purpose of the will; (ii) whether, as the Revenue contended, the tribunal had erred in failing to make certain findings of fact; (ii) whether, before 2002, the trustees had run a business separate from the deceased's farming business and whether the former had been carried on otherwise than for gain so as to be excluded from relief by operation of s 103(3) of the Act; (iii) whether the deceased had carried on a composite business of estate management and farming on the estate; and (iv) if so, whether on a proper analysis that business was to be characterised as one mainly of holding investments, so that BPR was not available by operation of s 105(3) of the Act. The Revenue accepted that if the second issue was answered in the affirmative, then the business had been carried on for gain.

The appeal would be dismissed.

(1) On the proper construction of the will, the tribunal had made no error of law in concluding that it had directed the trustees to grant to the deceased the powers equivalent to those of a proper liferenter (see [30]-[31] of the judgment).

Robert Mackenzie and another v Johnstone and another [1912] AC 743 applied.

(2) In deciding whether a finding of fact was perverse in the sense that the tribunal had acted without any evidence or upon a view of the facts which could not reasonably be entertained, there might be circumstances in which the Upper Tribunal in the exercise of its jurisdiction in relation to errors of law could hold that uncontested evidence, on which a first-tier tribunal had failed to make findings, gave rise to the inference that its decision on the facts was perverse. That was in some ways analogous to the finding in judicial review that a decision-maker had failed to take account of a relevant consideration which was material to his decision. But before the Upper Tribunal could overturn a decision on the ground of failure to make particular factual findings it had to be satisfied: (a) that it could properly make those findings; and (b) that the new findings, when considered together with the existing findings (which were either uncontested or survived challenge), pointed irresistibly to a conclusion which was contrary to that which the first-tier tribunal had reached. Unless both tests were met, the challenge had to fail. In relation to (a), the Upper Tribunal was not in a position to adjudicate upon disputes about what a witness said in unrecorded oral evidence. Such facts were not objectively verifiable. Nor was it charged with reconsidering all of the evidence which was before the first-tier tribunal in order to make its own factual findings; it was not a re-hearing on the evidence. Nor was it appropriate for counsel, when advancing such a submission, to cherry pick from the evidence points which when listed in a particular combination might give rise to inferential findings contrary to the decision under challenge (see [52]-[53] of the judgment).

In the circumstances of the instant case, the tribunal had made no error of law in its decision not make the further findings of fact sought by the Revenue (see [55]–[59] of the judgment).

Edwards (Inspector of Taxes) v Bairstow [1955] 3 All ER 48 considered; *McCall (personal representative of McClean, decd) v Revenue and Customs Comrs* [2009] STC 990 considered.

(3) In deciding what the term “the business of holding investments”, contained in s 105(3) of the Act, meant, the test which the decision-maker applied was that of an intelligent businessman who would be concerned with the use to which the asset was being put and the way it was being turned to account. The question whether a business consisted wholly or mainly of making or holding investments was a question of fact for the decision-maker. The decision-maker was required to look at the business in the round and, in the light of the overall picture, to form a view as to the relative importance to the business as a whole of the investment and non-investment activities in that business. That exercise involved looking at the business over a period of time. In so doing, the decision-maker could have regard to various factors, such as the overall context of the business, the turnover and profitability of various activities, the activities of employees and other persons engaged to assist the business, the acreage of the land dedicated to each activity and the capital value of that acreage. Not one of those factors was conclusive, as the exercise involved looking at the business in the round. While the decision-maker had to consider all relevant factors in relation to a particular business, there would be circumstances in which a factor, which was relevant to one business, was not relevant to another. The fact that the owner of an investment engaged in activities to manage and maintain his investment did not of itself take the business out of the investment category. In looking at the question in the round it was not appropriate in every case to compartmentalise the business and attribute management and maintenance activity either to investment or to non-investment as an ancillary activity. Because the question was a question of fact, the upper tribunal could interfere with the decision of the first-tier tribunal only if an error of law had been demonstrated (see [69] of the judgment).

On the evidence, the tribunal had been entitled to conclude that the deceased had operated the estate as one business before November 2002. There had been no error of law in that respect. Further, the tribunal had been entitled to conclude that s 105(3) of the Act did not apply because the deceased's business did not consist mainly of holding investments. In those circumstances, as the Revenue had accepted, the business had been carried on for gain (see [62], [80], [82] of the judgment).

Martin (Moore's Executors) v IRC [1995] STC (SCD) 5 considered; *Burkinyoung's Executor v IRC* [1995] STC (SCD) 29 considered; *Farmer (Farmer's Executors) v IRC* [1999] STC (SCD) 321 considered; *IRC v George* [2003] All ER (D) 102 (Dec) considered; *McCall (personal representative of McClean, decd) v Revenue and Customs Comrs* [2009] STC 990 considered.

Judge Reid QC [2009] STFD 374 affirmed.

Administration

Compliance checks factsheets

This brief explains the factsheets that HMRC issue to customers during compliance checks.

Introduction

This Business Brief explains the factsheets HM Revenue & Customs (HMRC) issue to customers during a compliance check. The factsheets are designed to help explain to them in plain English—

- how HMRC conduct compliance checks
- what powers it can use
- what safeguards are in place to protect their rights
- how HMRC work with the customer to reach agreement about their tax liability
- what penalties HMRC may charge and what the customer can do to reduce them
- when HMRC can publish the details of deliberate defaulters
- what tax or duty they apply to.

The factsheets are issued at different stages during the compliance check. Customers can also request a factsheet at any stage during a check or they can view and download them from the HMRC website. It is possible that they will pass these on to their accountant or tax agent.

The factsheets cannot explain everything about a subject but they do give the customer essential information so that they can make sensible informed decisions. The factsheets do not replace the detailed guidance in the Compliance Handbook(www.hmrc.gov.uk/manuals/chmanual/index.htm).

Background

Under the review of HMRC's powers, deterrents and safeguards (www.hmrc.gov.uk/about/powers-appeal.htm) legislation was introduced to align and modernise how HMRC administers the taxes and duties formerly handled by Customs and Excise and the Inland Revenue.

This included a new compliance checks system for how the department checks a customer's tax is correct. The new system came into effect from 1 April 2009 and consists of—

- new inspection and information powers
- aligned record keeping requirements
- aligned rules on computer records
- alignment of the time limits for making tax assessments and claims to four years from 1 April 2010

The new rules apply to Capital Gains Tax, the Construction Industry Scheme, corporation tax, income tax, national insurance contributions (Class 1 and 4), PAYE, and VAT from 1 April 2009.

Finance Act 2009 extended the earlier legislation to apply it to Aggregates Levy, Climate Change Levy, Inheritance Tax, Insurance Premium Tax, Landfill Tax, Petroleum Revenue Tax, Stamp Duty Land Tax and Stamp Duty Reserve Tax from 1 April 2010. The time limits for making tax assessments and claims were also aligned at four years but there are transitional arrangements so these do not become fully operative until 1 April 2011.

Other legislation introduced new penalty systems to support the compliance checks framework.

In addition s 94 established a system where HMRC could publish the details of people who were penalised for deliberately evading the payment of at least £25,000 of tax, and who did not fully cooperate with HMRC.

Details of the legislation involved can be found at Appendix 1.

CC/FS1- *GENERAL INFORMATION*

Factsheet CC/FS1 gives customers general information about compliance checks and their rights. It is issued with every opening letter or with the first letter telling a customer about a new compliance check.

CC/FS2 - REQUESTS FOR INFORMATION AND DOCUMENTS

Factsheet CC/FS2 explains what happens when HMRC ask for information or documents during a compliance check. It is issued with every information notice. Ch423100 (www.hmrc.gov.uk/manuals/ch1manual/Ch423100.htm) explains when HMRC will issue an information notice.

CC/FS3 - *VISITS—PRE-ARRANGED*

Factsheet CC/FS3 explains pre-arranged visits to customers and explains why HMRC may need to look at the business records or assets. It is issued in advance of all pre-arranged visits. Ch453000 (www.hmrc.gov.uk/manuals/ch1manual/Ch453000.htm) explains more about pre-arranged visits.

CC/FS4 VISITS—UNANNOUNCED

Factsheet CC/FS4 explains under what circumstances HMRC may need to make an unannounced visit and the safeguards that are in place to protect the customer. The customer will be given factsheet CC/FS4 at the same time they are given the Notice of Inspection. Ch454000 (www.hmrc.gov.uk/manuals/ch1manual/Ch454000.htm) explains more about unannounced visits.

CC/FS5 VISITS—UNANNOUNCED—TRIBUNAL APPROVAL

Factsheet CC/FS5 is given to the customer if a tribunal approves a visit because the customer has refused HMRC access to business premises, or HMRC have identified concerns that can only be dealt with by an unannounced visit. It also explains the penalties HMRC can charge if entry is refused, and the safeguards that are in place to protect the customer.

The customer will be given CC/FS5 with the Notice of Inspection. Ch454540 (www.hmrc.gov.uk/manuals/ch1manual/Ch454540.htm) explains how HMRC can seek the approval of a tribunal.

CC/FS6 WHAT HAPPENS WHEN WE FIND SOMETHING WRONG?

Factsheet CC/FS6 explains what happens when HMRC identify an inaccuracy in a return or documents, or a failure to notify. It explains how HMRC work with the customer to put things right and how HMRC charge or repay any tax difference that results from what it found.

CC/FS6 is issued when HMRC find something wrong during a compliance check, even if it may result in an overpayment of tax. It may also be issued at the start of a compliance check where, for example, a customer has made an unprompted disclosure or HMRC have made a discovery.

CC/FS7 PENALTIES FOR ERRORS IN RETURNS OR DOCUMENTS

Factsheet CC/FS7 explains when HMRC may charge a penalty for an inaccuracy in a return or document, the penalty ranges for the different types of disclosure and behaviours, and what the customer can do to reduce any penalty.

HMRC will issue or give the customer Factsheet CC/FS7 when they become aware that a penalty may be due. CH80000+ (www.hmrc.gov.uk/manuals/chmanual/CH80000.htm) explains penalties for inaccuracies more fully.

CC/FS8(T) HELP AND ADVICE

Factsheet CC/FS8(T) gives customers general information about compliance checks, their rights, and where to go for help and advice. It is issued only in cases where the compliance check has arisen from work done by HMRC's Targeted Education, Enabling and Leverage teams. It is issued at the start of a compliance check instead of the CC/FS1.

CC/FS9 HUMAN RIGHTS ACT

Factsheet CC/FS9 explains a customer's rights under art 6 of the European Convention on Human Rights when HMRC are considering penalties.

Factsheet CC/FS9 is issued or given to the customer when HMRC find something wrong during a compliance check and have reason to believe the customer may be liable to a penalty.

CC/FS10 SUSPENDING PENALTIES FOR CARELESS ERRORS IN RETURNS OR DOCUMENTS

Factsheet CC/FS10 explains what happens when HMRC have identified that a customer is liable to a penalty because of a careless inaccuracy in a return or document and it is considering if it can set conditions that will allow it to suspend the penalty.

CC/FS10 is issued when HMRC start to discuss the possibility of suspending a penalty for a careless inaccuracy in a return or document. CH83130 (www.hmrc.gov.uk/manuals/chmanual/CH83130.htm) explains when a penalty may be suspended.

CC/FS11 INFORMATION ABOUT THE FAILURE TO NOTIFY PENALTY

Factsheet CC/FS11 explains when HMRC may charge a penalty for a failure to notify, the penalty ranges for the different types of disclosure and behaviours, and what the customer can do to reduce any penalty.

It is issued or given to the customer when HMRC believe that a failure to notify penalty may be due. CH70000+ (www.hmrc.gov.uk/manuals/chmanual/CH70000.htm) explains more fully the failure to notify penalty.

CC/FS12 INFORMATION ABOUT VAT AND EXCISE WRONGDOING PENALTIES

Factsheet CC/FS12 explains when HMRC may charge a penalty for a wrongdoing, the penalty ranges for the different types of disclosure and behaviours, and what the customer can do to reduce any penalty.

It is issued or given to the customer when HMRC believe that a VAT or Excise wrongdoing penalty may be due. CH90000+ (www.hmrc.gov.uk/manuals/chmanual/CH90000.htm) explains more fully the VAT and Excise wrongdoing penalties.

CC/FS13 PUBLISHING DETAILS OF DELIBERATE DEFAULTERS

Factsheet CC/FS13 explains under what circumstances, and what conditions have to be met before, HMRC can publish the details of deliberate defaulters.

Factsheet CC/FS13 will be issued before HMRC start to discuss the possibility that a customer's details may be published or when HMRC have reason to believe they may meet the conditions for publication. CH190000+ (www.hmrc.gov.uk/manuals/chmanual/CH190000.htm) explains more fully about publishing the details of deliberate defaulters.

HMRC1 HMRC DECISIONS—WHAT TO DO IF YOU DISAGREE

Factsheet HMRC1 explains what customers can do if they do not agree with a decision they can appeal against. This includes details of how to ask for a review and how to appeal to the independent tribunal. Appeals, reviews and tribunals guidance (www.hmrc.gov.uk/manuals/artgmanual/index.htm) explains these processes more fully.

Where to find them

The compliance check factsheets (www.hmrc.gov.uk/compliance/factsheets.htm) and the appeals factsheet, HMRC 1 (PDF 65K) (www.hmrc.gov.uk/factsheets/hmrc1.pdf) are all available on the HMRC website.

Appendix 1

The legislation is contained in—

Finance Act 2007 - Section 97 and Schedule 24 introduced a simpler and more consistent penalty for inaccuracies in tax returns and other documents for the main taxes.

Finance Act 2008

- Section 122 and Schedule 40 extended the taxes the inaccuracy penalty could be applied to.
- Section 123 and Schedule 41 introduced a standard penalty for failing to notify HMRC about tax due.
- Section 123 and Schedule 41 introduced VAT and Excise wrongdoing penalties.

Across the main taxes—

- Section 114 aligned rules on computer records
- Section 113 and Schedule 36 created a framework of new inspection and information powers
- Section 115 and Schedule 37 aligned and modernised record keeping requirements
- Section 118 and Schedule 39 aligned and modernised time limits for making tax assessments and claims
- Section 119 streamlined the procedures for correcting returns and ending Corporation Tax enquiries

Together these changes created a new compliance checks framework for the main taxes and were announced on 12 March 2008 in Budget Note 97.

Finance Act 2009

- Section 95 and Schedule 47 amended Schedule 36 FA 2008 which contains HMRC's new information and inspection powers.
- Section 96 and Schedule 48 amended Schedule 36 FA 2008. Extend HMRC powers to the new taxes.
- Section 98 and Schedule 50 amend existing legislation to align the record keeping rules for environmental taxes, Insurance Premium Tax and Stamp Duty Land Tax.
- Section 99 and Schedule 51 contain provisions amending time limits that apply to assessment and claims.

Together these changes extend the new compliance checking framework to other HMRC taxes and were announced on 22 April 2009 in Budget Note 89.

Business Tax

Choosing the business vehicle

When someone decides to start in business, consideration should be given as to the most suitable type of entity for the business. This decision will depend on legal, commercial and administrative factors as well as taxation.

When advising on which type of business vehicle to choose, asking the prospective proprietor the following questions may help:

Who is starting in business?

One person alone

An unincorporated business or limited company may be suitable.

Consider the impact of the personal service company rules if the individual intends to operate through a limited company.

A group of people who aren't related

A limited company, partnership or LLP may be suitable, depending on the other relevant factors.

Family members, spouses

A limited company, partnership or LLP may be suitable, depending on the other relevant factors.

There are additional considerations when employing spouses or children - see section 3.9.

Regardless of whether a partnership or company is chosen, the settlements legislation may apply. For more on this see 3.8.

What are the intentions of the business?

'Lifestyle' business – aiming for profits sufficient to fund a good standard of living until retirement.

If profits are forecast from early on then particular consideration should be given to taxation of profits, NICs, net income required by proprietor and timing of payment of tax.

If losses are anticipated early on then more flexible loss relief for unincorporated businesses may be more important.

Hobby business – alongside employment with no requirement to earn a certain level of profit

The use of business losses is restricted where there is no intention of making profits.

Entrepreneurial – ambitious growth plans, with a defined route to exit via sale or flotation.

Generally a corporate vehicle will be more suitable if a sale is anticipated. This will not always be the case eg entrepreneurial professional partnerships may still operate as an unlimited liability partnership.

What external influences other than tax planning may impact on choice of business vehicle?

- Tradition;
- Expectations of customers / suppliers / contractors;
- Regulatory requirements;
- Requirements from insurers;
- Legal considerations;
- Requirement to attract external investors;
- Conditions attached to government / state grants;
- Activities of the company, eg if it intends to carry on R&D activities.

Sole trades and partnerships

The benefits of using an unincorporated business are:

- Comparatively easy to set up;
- Relatively easy to administer;
- Privacy – no requirement to file information publicly as under company law;
- Easy to cease if the business does not do well – so useful to test a business idea;
- Loss relief more flexible for unincorporated businesses and very useful in early years;
- Loss relief is available for NICs;
- There may be useful tax planning opportunities with tax credits;
- NICs are due on sole trader and partnership profits at more favourable rates than employer's and employee's rates.

Potential disadvantages include:

- Unlimited liability;
- Public may perceive the business as temporary / less safe to trade;
- Profits are taxed regardless of whether they are drawn or retained in the business;
- No relief from trading profits for proprietor's drawings, pension contributions etc.
- Certain tax reliefs are only available to companies (see below);
- Combined income tax and NIC rates compare unfavourably with corporation tax rates;
- In early years, profits may be effectively taxed twice as overlap profits.

Companies

The benefits of using a limited company are:

- Limitation of liability;
- Public may have a better perception of an incorporated business as a more serious and trustworthy operation than a sole trade, with more protection for creditors etc.
- Investors can benefit from enhanced tax reliefs eg. EIS;
- Certain tax reliefs and schemes are only available to companies eg. R&D tax relief;
- Ability to incentivise with share reward, possibly under a government-approved tax efficient scheme such as Enterprise Management Incentive scheme, Save As You Earn etc.
- Retained profits are subject to lower tax rates than unincorporated businesses;
- Ability to draw profits by way of dividends which may result in lower effective tax rates than rates applicable to profits of unincorporated businesses;
- Proprietor's salary, pension contributions, certain benefits, etc may be allowable as a deduction from trading profits.

Potential disadvantages include:

- Administrative burden on incorporation;
- Extensive ongoing filing obligations under company law;
- Directors’ duties;
- Public availability of company and director information;
- Remuneration paid by way of salary subject to higher rates of employee’s and employer’s NICs (although employer’s NICs are deductible from trading profits);
- The danger of and uncertainty over IR35 status – see recent case of Novasoft.

Partnership or LLP

The Limited Liability Partnerships Act introduced limited liability partnerships with effect from 6 April 2001. The words limited liability deal with the legal implications of being a Limited Liability Partnership (LLP). For legal purposes, a LLP is very similar to a limited company. The word partnership relates more closely to the tax treatment and for tax purposes a LLP is very similar to a normal partnership.

LLPs are generally set up by firms of professionals such as accountants and lawyers, who are required by the rules of their professions to operate as partnerships but who seek to have the protection of limited liability.

Formalities on setting up

Forming an LLP is like forming a company. Two or more persons, known as initial subscribers**,** must deliver an incorporation document to the Registrar of Companies.

The subscribers of an LLP are known as members**.** Thereafter new members can be added by agreement of existing members, and members may leave as long as at least two remain. There is no upper limit. The members of a LLP are very similar to the shareholders in a company.

LLPs must have at least two designated members – they are very similar to directors of companies. They are the members who are responsible for the management of the LLP. Their responsibilities include filing certain notices with the Registrar (such as when a member leaves), signing and filing accounts and appointing auditors (if required).

The incorporation document must show the following information:

- The name of the LLP;
- The place of registration, either in England and Wales or in Scotland;
- The address of the LLP's registered office;
- The names and addresses of the members of the LLP;
- Who the designated members are - the incorporation document may simply state that every member is also a designated member.

Members of a LLP

The rights and duties of the members of a LLP may be governed by a separate agreement. This is advisable as it clarifies each member's obligation to the LLP and to each other, but is not obligatory. Each member is an agent and may bind the LLP, so consequently if a member of a LLP signs a contract in that capacity, then he or she is bound by the contract as well as all of the other members.

The members' interest is basically the share capital of the LLP. Each member's interest must be separately analysed and must show the following:

- Capital contributed by each member;
- The loans to the LLP by each member;
- Monies owed by the LLP in respect of profits for each member - basically this is any undrawn profit;
- Any other amounts contributed by the member to the LLP.

Accounts and audit

There are also accounting and audit requirements that LLPs must adhere to. LLPs are subject to similar audit requirements to those of limited companies**,** ie. where turnover exceeds £5.6 million an audit will be required.

Where profits of the LLP exceed £200,000, the accounts must disclose the amount attributable to the highest paid member. When computing this profit, this is profit before members' remuneration.

LLPs must file accounts and an annual return. On insolvency, the rules that apply to companies also apply to LLPs under the Insolvency Act 1986.

Income tax implications

The profits of a trading LLP are subject to income tax based on each member's share of the underlying profit.

Like a normal partnership, it is the members who are liable to tax, not the LLP.

Also like a normal partnership, member's salaries are not deductible in arriving at the taxable profit.

LLP profits are also liable to Class 4 National Insurance, and each member will also be liable to Class 2 where the earnings of the LLP exceed the small earnings exception. LLP profits qualify as relevant earnings for pension purposes.

However, profits of a non-trading LLP are subject to corporation tax within the LLP - they are not subject to income tax on the members.

LLP losses

The liability for losses sustained by a normal partnership is unlimited, i.e. if a normal partnership makes a loss, each partner must contribute enough funds to that partnership to ensure the liabilities are settled. Consequently loss relief is available in full.

However, liability for losses in a LLP is limited - hence the reason this is a “limited liability” partnership.

Loss relief claims under s.64 or s.72 of ITA 2007 and s.261B of TCGA 1992 (ie. sideways loss relief) are restricted to each member's 'contribution' to the LLP. Claims can be made under these loss relief provisions to set the member's share of the LLP loss against non LLP income and gains.

Capital taxes

For Capital Gains tax purposes, each member owns an underlying share of each LLP asset. This is the same principle as for normal partnerships.

Assume an individual has a 40% share in a trading LLP. The LLP owns a property which is sold realising a capital gain of £100,000. This particular member will be liable to CGT on 40% of this gain. He will disclose this gain on his tax return for the relevant tax year. However, this £40,000 will be eligible for roll-over relief if a replacement asset is found within the roll-over relief period.

However**,** non-trading LLP gains are subject to corporation tax within the LLP.

For Inheritance Tax purposes, a share in an LLP qualifies for business property relief (BPR) at 100%. Again this same principle applies for normal partnerships.

However, if assets are held outside the LLP, i.e. in an individual member's own name, and are used for trading purposes by the LLP, then 50% BPR will be available in those circumstances.

Transfer of a partnership to a LLP

The transfer of a normal partnership to a LLP is often known as the incorporation of a partnership**.**

The transfer of a trading partnership to a LLP is a relatively painless process. There is no cessation of trade, and no balancing allowances or charges will arise. There will be no triggering of overlap relief**.** This is provided that the transfer creates a LLP identical to the partnership, i.e. the same trade is carried on by the new LLP, involving the same partners and there is not a de-merger.

For instance, assume an accountancy practice offers audit, accounting and tax consultancy services. If just the tax consultancy arm of the practice is transferred to a LLP, that would be a “de-merger”

and this would trigger a cessation of that tax consultancy trade in respect of the partners. If however, everything is transferred into the new LLP, that would not trigger any cessation provisions.

For VAT purposes, the transfer is treated as a transfer of a going concern and is thus outside the scope of VAT.

See HMRC Press Release 12/00 for more guidance on the taxation of LLPs.

Corporate partnerships

Introduction of corporate partners, usually as members of a LLP is becoming increasingly popular given the new 50% top rate of income tax with effect from April 2010. Provided that cash is not required by the individual members, profit share can be allocated to the corporate partner (who may have a small company rate band available of up to £300,000) and set aside until such time as it can be extracted hopefully at lower rates in the future.

Computation of taxable profits

UK partnerships, Limited Partnerships and Limited Liability Partnerships are transparent for UK tax purposes regardless of whether it has any corporate partners / members. Computing the amount of taxable profits from a partnership is therefore very similar for companies as it is for individuals.

Strictly, when a partnership includes a mixture of corporate and individual members, two computations of taxable profits must be carried out, one under the rules relating to individuals and the other according to rules relating to corporation tax.

Once the profit or loss has been computed, the amounts are included in the company's corporation tax computation. Losses are able to be used as normal except for the impact of anti-avoidance rules which restrict the use of losses from a partnership in certain situations.

Accounting period

For individuals, trading income is taxed on the "current year basis" – in other words the trading profits (or losses) of the accounting period ending in a given tax year are assessed to tax in that year. Under current year basis, individuals in partnership will not usually need to adjust the amount of income and expenses included in their partnership statement of the partnership tax return. On the other hand, companies are assessed to tax based on their profits computed in accordance with GAAP and so an apportionment exercise may be required where the accounting period of the partnership is different from that of the company.

Investment partnerships (ie partnerships which do not carry on a trade, profession or vocation) are assessed to tax on a tax year basis. This means that the computation may be complicated further if the partnership does not have a 31 March or 5 April year end, as the partnership results will have to be adjusted for the purpose of the partnership tax return, and possibly adjusted again for corporate partners with a different accounting period.

Tax returns

Partnership tax returns include a statement in respect of each partner, including corporate partners.

Once the partnership tax return has been approved by the nominated partner, a copy of each partner's partnership statement should be supplied to them as soon as possible to enable them to complete their own tax returns.

Practical problems

Because of differences in accounting periods, it is possible that a company is not in a position to file its own tax return including partnership profits or losses by the filing deadline. For example, say a company with a year end of 30 September 2010 is a partner in an investment partnership. The company has to include half the figures from the year ended 31 March 2010 and half the figures from the year ended 31 March 2011. The partnership return for the year ended 31 March 2011 does not have to be filed until 31 January 2012 and so it is likely that the company's tax return will not be able to be filed by the deadline of 30 September 2011.

In this situation the company may include provisional results based on management accounts. This would then require an adjustment in the following period to take into account any differences in the final figures. It is very important to ensure that the partnership and company tax return

figures reconcile year on year and include a clear reconciliation on file. It may also be advisable to include the reconciliation (together with any other workings required to compute the amounts of partnership income or expenses brought into the company's tax return) as a schedule to the company's tax computation.

Example

Kimberley Ltd and Mr Pitbull have been in partnership for many years and share profits in the ratio 2:1. The partnership's trading results for the year ended 30 September 2010 are as follows.

	Trading profits	Capital allowances
	£	£
Year ended 30 September 2010	99,000	33,000

Kimberley Ltd's taxable profits from the partnership are as follows:

	£
Year ended 30.9.10	
Trading profits	66,000
Deduct Capital allowances	22,000
Trading income – include on Corporation tax return	£44,000

Mr Pitbull's taxable trading income is as follows.

2010/11 Profits	- include on Self Assessment Tax Return	£22,000

Lecture B616 (17.07 Minutes)

Raising business finance

How to raise sufficient finance to commence and continue operating is the most important consideration for most types of business.

Some types of financing are tax efficient, for example EIS and VCT. Tax advice at an early stage on ensuring that these reliefs are available can help to attract investors.

Loans

Most businesses will have to take out a loan of some sort and the tax implications will differ depending on the terms of the loan and who it is from.

Companies

For companies, the taxation of loan interest is under the loan relationships regime. Generally, interest on bank loans and overdrafts is allowable when it is accrued in the accounts.

If a company has a loan from an entity other than the bank, then this treatment may not apply. A shareholder may lend his own money to the company. If a company pays interest on this loan or other types of loans to individuals then the "late paid interest" rules may apply. This means that if the interest on the loan is accrued but not paid over for more than 12 months after the year end, then it is allowable when paid rather than when it is accrued.

In addition there may be an obligation to withhold tax at source. If this is the case, then the company will have to report and pay this tax on a quarterly basis to HMRC using form CT61.

If an individual borrows money to purchase shares in a close company in which he owns at least 5% of the shares, then the interest paid on that loan may qualify for tax relief.

A potential complication as businesses grow is transfer pricing. If a company is "thinly capitalised" ie has a high ratio of debt to equity, then HMRC may restrict the amount of interest which is allowable for tax purposes where the lender and borrower are 'connected'. It is possible to apply for an agreement from HMRC on the amount of interest which may be allowed in an Advanced Thin Capitalisation Agreement ("ATCA"). The rules are complicated and negotiating the terms of the ATCA with HMRC may be a lengthy process. However it gives the benefit of a degree of certainty to the company, its investors and future purchasers. This is a key aspect of tax advice to companies which have private equity or similar investors.

There is an exemption from the transfer pricing rules for small and medium sized enterprises. However due to the way in which the size tests take into account associated enterprises, enterprises with large investors which would otherwise be exempt may find themselves within the provisions.

Where interest is disallowed under these provisions, a corresponding adjustment may be allowed for the recipient such that the receipt of the interest is not taxable.

Sole traders and partnerships

For unincorporated businesses, provided the loan is taken out for a business purpose (e.g. to buy stock, to pay staff wages or to buy an asset to be used in the trade), interest payments will be allowable expenses for tax purposes. This will include overdraft interest (providing the account is a genuine business account and is not used to fund personal expenses).

Where the loan is taken out for a "mixed" purpose (for example, to buy a car where the car is used for both business and personal use), only the business proportion of the interest is allowed.

No deduction is allowed for the repayment of the capital part of the loan itself. Monthly loan repayments will therefore need to be split between the interest and the capital repayment elements.

No deduction is available for interest on overdue tax (as this is not an expense incurred in the course of making profits).

Incidental costs of obtaining loan finance (e.g. loan arrangement fees etc) are allowed.

If an individual borrows money to contribute capital to a partnership, then the interest paid on that loan may qualify for tax relief.

Fixed asset financing

Businesses may finance the acquisition of fixed assets by way of a financing agreement with the dealer – for example when purchasing a car or photocopier etc.

The tax treatment depends on the type of financing arrangement. In broad terms, a Hire Purchase agreement is treated as if the trader owns the asset themselves, and an operating lease is treated as a pure rental agreement. A Finance lease arrangement is somewhere in between.

Tax reliefs

Availability of tax reliefs is often an important part of a small business's financing strategy. For example, businesses may be able to benefit from tax reliefs such as:

- R&D tax credits;
- First Year capital allowances;
- Annual Investment Allowance;
- Business Premises Renovation Allowance;
- Film production tax credits.

Where the availability of relief is key to the success of the business, it is really important to consider the most appropriate structure as soon as possible.

Enterprise Investment Scheme ("EIS")

The Enterprise Investment Scheme offers substantial tax incentives to investors in companies which qualify. There are stringent conditions and tax advice on EIS should be undertaken and supervised by a suitable experienced tax practitioner. Terms of engagement for EIS work should be carefully drafted, in particular because conditions are tested on an ongoing basis and tax advisers should ensure that they are not liable for the results of future action (which are out of their control) affecting qualification for EIS.

In summary, tax reliefs under EIS are as follows:

- Income tax relief for the investor of up to 20% of the amount invested;
- Disposals of EIS shares after three years may be free from CGT;
- CGT deferral relief allows investors disposing of any asset to defer gains against subscriptions in EIS shares;
- Losses on EIS shares may be offset against taxable income;
- EIS investments should qualify for IHT BPR after two years' ownership.

Venture Capital Trusts ("VCTs")

A VCT is a company, which is approved by HMRC which subscribes for shares in, or lends money to, small unquoted companies similar to EIS companies. Under the VCT scheme, VCTs and their investors enjoy certain tax reliefs which are similar to tax reliefs afforded under the EIS.

Small Business Loans and Grants

Businesses may also be able to apply for grants or government loan schemes.

Some examples of special small business schemes at the time of writing are:

- Enterprise Finance Guarantee – assistance for businesses which would not otherwise qualify for a loan;
- Small Loans for Business - loans of up to £50,000 to SMEs which have not been able to obtain loan finance;
- Finance for Business – finance solutions for businesses which cannot obtain finance from commercial banks and investors.

For more guidance the Business Link website is a useful and comprehensive source of information.

www.businesslink.gov.uk

Lecture B617 (10.07 Minutes)

Ownership of business premises

Introduction

The proprietor may choose to retain the business premises and extract profits by way of rental income from the company.

He or she may either retain the property personally on incorporation of a new company or transfer the property out of an existing company at a later date.

There are many considerations other than taxation, ie commercial and legal, as to whether the individual proprietor or the company should retain ownership of business premises. Planning relating to property transactions should be carried out under specific terms of engagement, supervised by an experienced tax adviser.

In overview, the main considerations in some common scenarios are highlighted below.

Proprietor retains business premises

- Increase in value is subject to Capital gains tax at 28%;
- Commercial rent paid to the proprietor by the company is a deductible trading expense;
- Property income from commercial rent is taxed on the individual at his or her marginal rate;
- No NICs are due on rental income;
- Rental income is taxed via self assessment;
- Receipt of rent from company may impact on the availability of entrepreneur's relief;
- IHT Business Property Relief available at 50% where conditions met;
- More flexible on sale or cessation of company – the proprietor can retain the property and continue to receive rental income, or dispose of the property to the purchasers of the company;
- If the company relocates then the proprietor can retain the property as an investment.

Where the rent paid is more than a commercial rent, then the excess will be taxable either as a dividend or as remuneration (on which PAYE and NICs apply).

Company owns business premises

- Increase in value subject to Corporation tax at company's marginal rate;
- Companies benefit from Indexation Allowances whereas individuals do not;
- If company disposes of property then further tax will be due on extraction of profits from disposal;
- Need to consider the impact of owning the property on capital tax relief trading requirements;
- IHT Business Property Relief available at 100% where conditions met.

Extracting property from a company

If a proprietor transfers the property out of an existing company after incorporation, there are several possible tax consequences.

The proprietor and the company are likely to be connected parties for capital gains tax purposes. As such, the deemed proceeds for the transaction will be market value regardless of the consideration paid.

If HMRC considers that the price paid is too low, the difference between the amount paid and what it considers market value is subject to income tax as a distribution or a benefit in kind for the proprietor.

If the proprietor acquires the property and leaves the consideration outstanding on loan account, then the loans to participators rules may apply. Tax will be due at 25% by the company on amounts outstanding 9 months after the year end. There may also be a benefit in kind if the individual pays interest at less than the official rate.

Stamp Duty Land Tax is payable unless the property is transferred via a distribution in specie.

Ideas – proprietor has insufficient cash to purchase property

If the proprietor has no cash to pay consideration for the property it may be worth considering a transfer by distribution in specie.

The company will pay corporation tax on the market value of the property at the time of the transfer. The individual pays income tax as if he has received a distribution of the same amount.

As an alternative, the company can pay a bonus to the proprietor to enable him to purchase the property.

Working from home

Clients trading through a company and working from home should consider setting up a non exclusive rental agreement between the company and the individual.

Rental payments can prove advantageous as the company may deduct the rents in arriving at its corporation tax profit, provided that such rents do not exceed a commercial arm's length amount. It is advisable to put in place a formal rental agreement and have independent rental valuations carried out by a suitably qualified expert on a regular basis. Failure to instigate this may lead to a HMRC challenge on the deductibility of the rents.

It may be easier to keep a note of the rental rates that local serviced offices charge. Serviced offices are very common and rental rates tend to be based on the size of the office space. It should also be noted that the serviced office rental rates are generally inclusive of utilities and insurance so the comparison is reasonable. If your rental charge is in line with local serviced office rentals it should satisfy the market value test.

In order to prevent the loss of Principal Private Residence relief on the ultimate disposal of the home it is advisable to state in the agreement that the facilities are only let to the company for designated hours each week, for example, 9.00am to 5.00pm Monday to Friday.

The individual will need to declare the rent on their self assessment property pages. As the individual has a source of property income they would get deductions for any costs "wholly and exclusively" incurred for his property business. Effectively the same basis as a self employed person – a proportion of mortgage interest, council tax, home insurance, light and heat etc.

Interaction with buy to let losses?

Where clients have buy to let losses it should be noted that any "profit" the client makes on their use of home as office rent can be offset by any buy to let losses the client has on other UK properties. As long as the charge from the individual to the company is at market value, the home office rent is part of the client's UK property business. Hence losses on a buy to let are automatically offset against the home office profit.

Lecture B618 (10.32 Minutes)

Interest on client accounts

The appellant partnership was a firm of solicitors carrying out conveyancing work, principally re-mortgage transactions. The firm's clients were lending institutions advancing money to homeowners on the security of their homes and which was then used to pay off an existing mortgage. The firm's fees were paid by the lending institution. That fee alone did not cover the cost of doing the work. However, the amount to be lent to a homeowner was paid to the appellant on the day fixed for completion of the transaction, or the working day before, and so the appellant was able to earn additional income from the interest paid to it by its bank on the balance in its clients' account. It was understood between the firm and the client that the reward was made up of the fees and the retained interest; and was taken into account when negotiating the fee. The volume of work undertaken meant that the aggregate balance in the clients' account, and the corresponding interest earned on it, was significant. In its partnership tax return for the year 2006–2007 the appellant treated the retained interest on the clients' account as part of the firm's trading income. HMRC amended the return on the basis that the retained interest should be taxed in accordance with ITTOIA s 369(1), which provides "Income tax is charged on interest". The appellant appealed contending that (1) the priority rule in ITTOIA 2005 s 336(1)–which provides "Any income, so far as it falls within–(a) any Chapter of this Part, and (b) Chapter 2 of Part 2 (receipts of a trade, profession or vocation), is dealt with under Part 2"–was sufficient authority for the taxation of the interest in accordance with s 5 (and which would also result in its being able to offset past trading losses against current year interest gains). Section 5 provides that "Income tax is charged on the profits of a trade, profession or vocation"; and (2) the common understanding of the firm and its clients was that the money received in respect of advances would be used in its business, and retention by it of the interest earned would result in a reduction in the fees charged to the client. The interest was accordingly earned on money used for the firm's trading activities and it was the product of those trading activities. Thus it was quite unrealistic to regard it as income from savings or investments; it naturally came within ITTOIA 2005 s 5. HMRC argued that (1) under ITTOIA 2005 s 2(3)–entitled "Overview of priority rules"–the rules had "to be

read with the other rules of law (whether in this Act or otherwise) about the scope of particular provisions or the order of priority to be given to them." ITTOIA 2005 was drafted in the course of the Tax Law Rewrite Project and had to be read together with the Explanatory Notes produced as part of that Project. The note relating to s 2(3) read "Subsection (3) recognises that it is necessary to look at the scope of the charging provisions as well as the priority rules. It is also a pointer to … case law." The Explanatory Notes said, in relation to new material, that "In the main, such changes are intended to clarify existing provisions, make them consistent or bring the law into line with well established practice." That practice was enshrined in TMA 1970 s 9D, added by the FA 2001; and (2) the interest in the present case could not be regarded as trading income because it was earned from money which belonged to others, the firm's clients; it was not capital at risk in the business.

The tribunal considered that whilst it might be that the Rewrite Project did not intend to make material changes, ITTOIA 2005 s 366(1) was in unambiguous terms which might be overridden, by virtue of s 2(3), only by another rule of law. However, TMA 1970 s 9D was repealed by ITTOIA 2005. It was not possible to favour a repealed provision over another provision which at the material time was in force, and which was contained in the very enactment which was effected by the repeal. All that preceded s 9D (and the earlier provision it replaced) was practice; but practice, however well established, was not a rule of law. Therefore the earlier Crown Option practice and the repealed s 9D could not impede the taxation of the relevant income in accordance with ITTOIA 2005 s 5, provided that it was properly described as "the profits of a trade, profession or vocation."

The tribunal considered that the interest on the clients' account was earned in the course of the solicitors' trading and was an integral part of the trading activities. It was money which the solicitor received from his clients in return for his professional services, even if it was indirectly received. It was not interest earned on money set aside to meet future liabilities, nor interest casually earned. It was not a case in which carrying on the profession of a solicitor gave rise to the opportunity of earning interest, but one in which the interest was properly to be regarded as part of the solicitor's trading income, because it was understood between the solicitor and client that the interest would form part of the total fee. Accordingly, after applying ITTOIA 2005 s 2(3), the interest in the present case was properly to be regarded as trading income and was to be taxed in accordance with s 5. It followed that the appeal would be allowed; Nuclear Electric plc v Bradley [1996] STC 405 and Northend v White & Leonard and Corbin Greener [1975] STC 317 distinguished.

Appeal allowed.

Barnetts (a firm) v Revenue and Customs Comrs TC 575

[2010] UKFTT 286 (TC)

Corporation Tax

Consideration for exclusive rights – capital or revenue

The appellant company was the leading seller in the country of mortgage related products through an estate agency network operated by the C group of companies, which also included financial services and life assurance divisions. It occupied premises with the estate agents on the high street and it acted as an intermediary for the network. The appellant was permitted to introduce C's life insurance products to the estate agents' potential customers. The customer details belonged to C, but names and addresses were kept on the appellant's records. In its paper, FSA 121, the Financial Services Authority, announced its proposal to remove 'Polarisation' with the result that intermediaries in the appellant's position had to choose between either handling the product of one product provider or being entirely independent and operating as an independent financial adviser. In 2002 C decided to cease to write new life policies. In August 2002 the appellant entered into an exclusive life insurance distribution agreement ("the agreement") with the insurance company ("FP"). Under the agreement FP agreed to pay the appellant £25 million up front as consideration for its exclusive right to distribute life products to the appellant's customers, and it also agreed to pay commission in respect of each life product sold. The appellant undertook not to distribute any contracts of long term insurance, which were an integral part of a mortgage or property related transaction, other than those under written by FP. In its corporation tax return for the year ended 31 December 2002, the appellant treated the £25 million as a capital receipt on the grounds that the payment did not form part of its profits or gains arising in 2002 or in any other period. It argued that the entire payment was capital in nature as it was received in return for its grant to FP of the exclusive right to distribute life products for 15 years, thereby giving up the right to exploit its customer base. The goodwill consisted of its customer base (present and future) that rested on its reputation and on its geographical spread. HMRC issued a notice of amendment charging corporation tax on the payment on the basis it accrued when the appellant entered into the agreement and fell to be taxed as and when recognised by the appellant as a profit under recognised accounting principles. The appellant appealed.

The tribunal considered that there was no single test to determine whether a receipt was of a capital or income nature. The case law showed that sums paid for giving up or modifying a capital asset held by the recipient would be of a capital nature, as would sums paid for the cancellation of contractual arrangements that effectively destroyed or crippled the whole structure of the recipient's profit-making apparatus. In the instant case, the appellant neither parted with a capital asset nor was its profit-making apparatus depleted or destroyed. On the facts the £25 million payment was made to the appellant as an intermediary: it did not own any rights to distribute life products. The appellant's goodwill as a financial intermediary at all times depended on its position in the market. The name of the estate agents group and the appellant's association with and presence in the group's premises were continuing features of its goodwill and gave it access to customers. The effect of the agreement therefore was to give FP access, through the appellant, to those customers. On that basis the appellant could not be said to have parted with any significant element of its goodwill to FP. The same was true of the customer information that belonged to the appellant. It was using its access to customers by giving FP the right to be introduced to them. Therefore FP's £25 million payment was the consideration for the appellant undertaking to give FP access to the appellant's position in the market and its enhanced ability to introduce FP products to customers of the estate agency group. Furthermore the appellant did not—by foregoing the opportunity presented by the end of Polarisation—part with a capital asset by entering into an exclusive trading agreement with FP. It had never been part of the appellant's business activities to act as a financial intermediary for more than one life insurance provider. At most the agreement meant the appellant lost the chance to be financial intermediary for other providers. That was a possibility, not an asset. The appellant had used its goodwill and turned it to account through the agreement as its method of trading; it had not parted with part of its property for a purchase price. Accordingly the £25 million was income in nature. It followed that the appeal would be dismissed.

Appeal dismissed.

Countrywide Estate Agents FS Limited v Revenue and Customs Comrs

MJP Media Services Ltd

The taxpayer company, MJP Media, was a wholly-owned subsidiary of Carat International, which itself was wholly owned by Aegis plc.

Between 2001 and 2004, various inter-company transactions took place between MJP and Aegis, resulting in Aegis owing MJP more than £6.8 million.

MJP Media claimed the amount in its 2004 corporation tax computation as a deduction. HMRC refused the claim.

The company appealed, claiming the transaction fell within the loan relationship rules in FA 1996, s 81 (now CTA 2009, s 302).

The First-tier Tribunal noted there was a lack of documentary evidence - for example, bank statements - to support the company's claim, and none of the company's witnesses had personal knowledge of the transactions.

It was for the company to prove it had lent money within s 81 and, on balance, the tribunal decided the company had failed to do so.

The company's appeal was dismissed.

Gripple Ltd v Revenue and Customs Commissioners

The judgment is available at: [2010] EWHC 1609 (Ch)

Paragraph 5 of Schedule 20 to the Finance Act 2000 provides so far as material: '(1) For the purposes of this Schedule the staffing costs of a company are (a) the emoluments paid by the company to directors or employees of the company, including all salaries, wages, perquisites and profits whatsoever other than benefits in kind; (b) the secondary Class 1 national insurance contributions paid by the company; and (c) the contributions paid by the company to any pension fund (within the meaning of section 231A(4) of the Taxes Act 1988) operated for the benefit of directors or employees of the company. (2) The staffing costs of a company attributable to relevant research and development are those paid to, or in respect of, directors or employees directly and actively engaged in such research and development.'

The claimant company (the taxpayer) was an engineering company. At all material times, H was the director of the taxpayer. He was also the director of an associated company, LH, a former wholly owned subsidiary of the taxpayer. H carried out research and development work for the taxpayer on behalf of LH. His salary had at the relevant time been paid by LH. LH sent an invoice to the taxpayer by way of recharge in respect of the work carried out and the taxpayer made payments to LH. Subsequently, the taxpayer paid corporation tax under the corporate self assessment regime on the footing that it was entitled, as a small or medium sized enterprise, to claim tax relief, pursuant to Sch 20 to the Finance Act 2000 (the Act), as amended by the Corporation Tax Act 2009, for the research and development work carried out by H. The Revenue and Customs Commissioners (the Revenue) found that the taxpayer was not entitled to claim relief for the work carried out by H when his salary had been paid by LH. The taxpayer appealed to the General Commissioners of Income Tax (the commissioners), who dismissed the appeal having found that the sums paid by the taxpayer were not 'staffing costs' within the meaning of para 5 of Sch 20 to the Act. The taxpayer appealed to the High Court.

The issue for consideration was whether the Revenue and the commissioners had misdirected themselves as to the application of Sch 20 of the Act in respect of the expenditure of the taxpayer relating to the cost of the services provided by H. The taxpayer submitted that the commissioners had interpreted para 5(1)(a) of Sch 20 to the Act too narrowly and that they had failed to interpret it in the light of the wording in Para 5(2) of the Act. Paragraph 5, it submitted, should be construed so as to include emoluments paid indirectly by a company to a relevant director or employee, and that the recharge arrangement in the instant case, between two closely related companies, should be characterised as an indirect payment of emoluments by the taxpayer to H. It essentially argued that the taxpayer had paid half of H's remuneration by channelling it to him through LH. Alternatively, the taxpayer submitted that it was an appropriate case for the court to lift the veil of incorporation

and to treat the taxpayer and LH as a single commercial entity that had undertaken research and development.

The appeal would be dismissed.

(1) The purpose of para 5(2) of the Act was not to expand the meaning of 'staffing costs', which had already been exhaustively defined in para 5(1), but rather to explain which staffing costs were to be treated as 'attributable to relevant research and development'. Paragraph 5(2) set out the circumstances in which expenditure attributable to research and development was to be treated as attributable to staffing costs, namely when it was 'paid to, or in respect of, directors or employees directly and actively engaged in such research and development' (see [25] of the judgment).

In the instant case, the sums recharged by LH to the taxpayer in respect of H's services could not be treated as staffing costs within the meaning of para 5(1)(a) as they were not emoluments paid by the taxpayer to H. The taxpayer could not gain assistance from the wording of para 5(2) of the Act. All emoluments paid to H over the relevant period had been paid to him by LH. (see [24] of the judgment).

(2) It was settled law that, in respect of taxes, companies in a group, however closely related, were normally to be treated as separate entities. There was no authority which provided any support for the notion that the court should somehow coalesce separate corporate entities in construing fiscal legislation, unless the legislation properly construed permitted such an approach. In the absence of express provision in the Act, the general principle had to be to respect the separate corporate identity of the group members, and the question whether the preconditions for grant of relief had been satisfied had to be answered accordingly (see [23] of the judgment).

It followed that the taxpayer's submission about lifting the corporate veil could not be accepted (see [23] of the judgment).

Harmel v Wright (Inspector of Taxes) [1974] 1 All ER 945 considered; *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 3 All ER 462 considered.

Published Date 30/06/2010

Williamson Tea Holdings Ltd

The taxpayer company's entire shareholding in Borelli Tea Holdings Ltd were sold to another company, M.

At the time, the company had a 70% shareholding in Williamson Tea Assam, a company incorporated in India.

HMRC agreed that the sale of shares in Borelli attracted the substantial shareholdings exemption under TCGA 1992, Sch 7AC.

The share sale agreement included a non-competition agreement with M, for which M paid the appellant more than £3.7 million. HMRC treated this payment as a capital sum for the part-disposal of the appellant's goodwill.

However, the taxpayer company in its corporation tax return showed the amount as not taxable. It claimed that the non-competition agreement had been an artificial device to enable M to pay a lower price to the minority shareholders.

There was never any intention to compete with M after the sale.

The First-tier Tribunal said that HMRC had not produced any evidence to show that goodwill existed and had been disposed of under the agreement. The judge found that the agreement did not involve an agreement by the appellant not to exploit goodwill.

The consideration paid for the agreement therefore qualified for the substantial shareholdings exemption.

The taxpayer's appeal was allowed.

Moneys mistakenly paid to a trader

The issue

Pertemps is a UK incorporated and resident company.

The issue was whether sums of money mistakenly paid by customers to the Appellant, “Pertemps and not repaid, were liable to corporation tax under section 18(3) Income and Corporation Taxes Act 1988 ("ICTA").

Pertemps said that they were not.

The facts

Pertemps is a recruitment agency providing temporary and permanent workers to its customers. Where Pertemps provides a temporary worker, it pays the worker, and recharges the customer for the worker's costs plus a management fee. Where Pertemps provides help to enable a customer to engage a permanent worker, it charges the customer a recruitment fee. Pertemps invoices its customers in respect of these services.

Payments are received by Pertemps either by cheques in the post, or by direct credit to its bank account by BACS. Either way, all receipts (cheques and BACS direct credits) are made into the same single bank account from which business expenses incurred by the company are paid.

The sales accounts team posts all receipts to the sales ledger as quickly as possible on the day of receipt. Despite lengthy efforts made by Pertemps to unite payments with outstanding debts, some payments cannot be reconciled. The majority of unreconciled payments are either offset against another liability of the customer, or are repaid. Only in a minority of cases are payments neither offset against another liability nor returned to the customer.

Money received from unreconciled amounts remains in the same bank account as reconciled amounts.

Every six months Pertemps reviews unreconciled balances in the sales ledger. Those that are more than six months old are transferred to a balance sheet account. At the end of each financial year, this balance sheet account is released to Pertemps' profit and loss account as part of its year end procedures.

Pertemps keeps a full history of all payments received. If a customer can show that it has made an overpayment in error, Pertemps has and will refund the overpayment, even if the payment has been transferred to a balance sheet account or has been released to the profit and loss account under the procedures described above.

Findings

The Tribunal found that:

- each of the over payments was made by a customer under a mistaken belief that it owed money to Pertemps for services Pertemps had supplied to it. They emphasised that there was no suggestion that Pertemps conducted its business so as to encourage the receipt of the overpayments.
- the payments were derived from the business relationship that Pertemps had with its customers.
- Pertemps treated the overpayments as its own money. The overpayments were not segregated in any way from other receipts, and were paid into the same bank account. Money in this bank account being used to meet Pertemps' expenses.
- amounts paid by mistake to Pertemps by customers belong to Pertemps unless and until the customer makes a successful claim in restitution against Pertemps, or such a claim is settled by agreement. In practice as soon as a customer discovers its mistake, it will make a claim for a repayment. Pertemps therefore remains at risk of restitutionary claims irrespective of the length of time that has elapsed since the mistaken payment was received.

A mistaken payment for services has the same characteristic in the hands of the recipient trader as a payment made not in error – if the payment is made because the customer makes a mistake about owing something for services or for a trading transaction, the mistaken payment accrues from the trade of the recipient.

The Tribunal noted that Stamp LJ in *John Reynolds* (at 274-275) used as an example of a trading receipt a payment "... made to satisfy any legal liability, real or imagined, to which the customer was or believed itself to be subject."

HMRC submitted and the Tribunal agreed that the overpayments are a natural consequence of the efficient and lawful way in which Pertemps conducts its business, and that these processes will mean that sometimes it makes more money from the supply of its services than it had anticipated. In doing so, it has supplemented its trading profits, and the receipt is a trading receipt.

The appeal was dismissed.

TC00519: Pertemps Recruitment Partnership Ltd

Interfish Ltd v Revenue and Customs Comrs

The appellant company, which was involved in the fisheries industry, made substantial sponsorship payments, amounting to £1.2 million, to a rugby club in Plymouth over a three year period. The company lent money to the club and also covered a deficit in the club's player budget. In its corporation tax returns the company sought to deduct those payments in computing its profits on the basis they were "wholly and exclusively laid out or expended for the purposes" of its trade within the meaning of TA 1988 s 74(1). HMRC disallowed the claims on the basis that the purpose of the payments was, at least in part, to support the club "as an end in itself" and to enable the company's founder and controlling director (C), a keen rugby-player and enthusiast, to pursue his personal interest in the club—where he was a director—and that the payments were not apt to further the company's trade. The company appealed contending the payments were made with a view to securing—and did secure—the following benefits for its business: (i) C's position as a director and benefactor of the club "opened doors" within the company's bank, thereby enabling it to obtain loans, and also within the Plymouth business community as the club acted as a focal point; (ii) the payments enabled it to use the club for business hospitality purposes and C's status within the club assisted in that end; and (iii) they improved the visible promotion of the company brand, which was included on the club rugby shirts, advertising hoardings and the club's website. In the event that the payments were not deductible in their entirety, he argued that a portion could be deductible. HMRC argued (i) that to be deductible, expenditure had to be exclusively for trade purposes and that "dual purpose" expenditure was not deductible; (ii) the expenditure could not have been for the purposes of the trade; or at least was "dual purpose"; (iii) there was a presumption that an excessive payment was not for the purposes of the trade. The payments in the instant case were excessive in relation to the visible benefits; and (iv) supporting the club was an end in itself. The payments were not apt to further the company's trade: its customers were primarily business purchasers not located in Plymouth or south western England, so that promotion through the club was not an effective way of reaching them.

The tribunal considered that the requirement of "wholly and exclusively … for the purposes of the trade" in TA 1988 s 74(1) was a restrictive one and did not allow the deduction of sums (and in the present case, substantial sums) laid out for the purpose of promoting the trade of someone other than the taxpayer, in circumstances where the "knock-on" benefits to the taxpayer's trade, while real, were intangible and hard to quantify. On the facts the payments were tailored to the requirements of C's business. C wished to benefit the club so that the company might benefit. Therefore the company's purpose in making the payments was to improve the financial position of the club, so that that those involved with the club would look favourably on the company in ways that would assist its trade. Accordingly promotion of the business of the club was not an unintended consequence of the company's payments; it was a consciously intended consequence and, indeed, necessary if the company were to derive benefit. The business interests of the company would not be furthered, or at least not as effectively, if C were not seen to be the benefactor of the club. In circumstances, such as those in the present case, where a payment had more than one purpose, the issue of deductibility was not determined by the taxpayer saying "the

purpose I had in mind was securing the trade advantage”. C was aware of the benefits to the company when he made the payments. He was not using the company's funds to finance the club simply in order to give himself the satisfaction of being the benefactor of the club or of enjoying the status which that position carried with it. However, he could not have been confident that the financial benefits to the company business would necessarily be equal to the amounts the company was contributing; some £1.2 million in the relevant financial periods. The benefits for the company of presence and influence among the local business community were intangible and difficult to quantify financially and would have hampered any attempt to predict whether the company would get a commensurate return on its money. It followed that the sums paid by the company for the purposes of increasing the player budget were not deductible. The appeal would be dismissed.

Appeal dismissed.

Associated companies updated

Basic position

Companies are associated if one of the two has control of the other, or both are under the control of the same persons. Then, the £300,000 profit level for the small profits rate of corporation tax is spread equally between each associated company. This of course can result in far less than £300,000 of profits enjoying the 21% rate.

For two companies to be under the control of the same persons, an irreducible group of persons having control of one must be identical with an irreducible group of persons having control of the other. This means that no definition of control could be satisfied if any one of them was excluded.

See HMRC’s *Marginal Small Companies’ Relief Toolkit* for a checklist approach.

Finance Act 2008 changes

The concerted attack by HMRC in cases where the existence of an associated company may not be known or anticipated (the prime example involves an LLP used for a film scheme) collapsed following FA 2008, although they did not cover other unfair examples of companies being associated.

From 1 April 2008 the rights and powers held by business partners are only attributed when relevant tax planning arrangements have at any time had effect in respect of the taxpayer company. That covers arrangements which involve the shareholder or director and the partner, and secure a tax advantage because of greater small companies relief.

Further changes

In the Finance Bill 2011 there will be a further relaxing of the rules from 1 April 2011 where rights held by linked persons are attributed to them to establish control. It proposes that whilst the rights of a person and his nominees will always be taken into account, the rights of others (e.g spouse) will only be relevant in limited circumstances – specifically by reference to factors determining substantial commercial interdependence. Following a consultation process the proposal is to introduce three categories of linkage. Draft legislation has been published, amending the definition of an associated company in Section 27 CTA2010 and introducing the *Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Order 2011.*

Financially interdependent

This is where a business is unable to operate without the necessary funds and financial backing to do so. Signs of financial interdependence include:

- Financial support given by one company, or its owner(s), to another company or companies such that the company would not be viable without the support from the other(s). The support may be directly to the company, or via guarantees or cross-guarantees.
- The separate companies share a common financial interest in the affairs of the same business.

Economically interdependent

Indicators include:

- Separate companies are seeking to realise the same economic objective.
- The activities of one company benefit the other(s).
- The companies have common customers.

Organisationally interdependent

Where there are direct and immediate organisational links between separate companies, such that they could not reasonably be run by a third party at arm's length from the other(s), they may be parts of a single enterprise. Points to consider are:

- Common management
- Common employees
- Common premises
- Common equipment

In many cases the only linkage might well be the use of common premises. although economic interdependence might also be a potential test. The draft new paragraphs *CTM03790* and *CTM03795* of the *Corporation Tax Manual* gives these examples within these tests:

A and B are brothers who have built up successful internet businesses from modest beginnings when sharing a flat together as students. Right from the start both were interested in the business possibilities of web site design. A is the major shareholder and director of Company P which provides professional web design services, and B is the major director and shareholder of Company Q which provides graphic design services. Although their developing businesses benefited from the mutual exchange of ideas, especially in the early days, the brothers have had no other involvement in each other's businesses, which operate entirely independently. The economic links between the two companies are too tenuous to associate them.

C is the major shareholder in Company Y and a 49 per cent shareholder in Company Z. The two companies operate a large public house, which is popular for family dining as well as having a thriving wet trade. Company Y handles wet sales and Company Z, which is run by the majority shareholder, C's wife, manages the catering operation. Mrs C has financed the purchase of the assets of the catering business from a family legacy and a loan to Company Z which she is guaranteeing personally. Both businesses are insured separately. Each business fully meets its own costs, and the catering business is charged a commercial rate for the use of the shared premises, employees and facilities. Although there is no cross subsidy, the two companies share a common economic goal with a common customer base and mutually beneficial activities. In addition, the two companies are organisationally interdependent, sharing premises and employees. The two companies are accordingly associated.

Mr Q is the major shareholder in Company C which runs a large Chinese restaurant. It also operates a Chinese supermarket backed by its reputation as a restaurant. Mrs Q, who is a chef trained in France, is the sole shareholder in Company D which runs a gastronomically starred restaurant she has built up from scratch. Company D also imports delicacies from all over the world for sale on the internet, again backed by its reputation as a restaurant. Although Q and Mrs Q are husband and wife

and in the same trade, there is no link between their companies, which have been trading since well before they knew each other. They are not associated.

M is the major shareholder in Company R, a dry cleaning business. Mrs M has opened a second dry cleaning business in the same town. This is run by Company S, of which she is the sole shareholder. Company S offers specialist services in relation to wedding and evening dresses in addition to the normal range of dry cleaning facilities. Company R acts as agent for these specialist services which it does not have the ability to supply itself. Company S and Company R share the same basic economic objective and their activities are of mutual benefit. The companies are therefore associated.

X is the director and sole shareholder of Company R which operates a chain of shoe shops. His wife also runs a shoe shop through Company S. Although the two companies are in the same line of business, there are no links between them and they operate entirely independently. Mr X and Mrs X started their individual businesses long before they met and they have kept the two enterprises entirely separate. The two companies are operated by associated individuals but there is no link between them, they are not associated.

Mr and Mrs B each run their separate companies from their family home which is owned by Mrs B. Mr B's company could not afford to buy or rent other accommodation to trade from. Apart from sharing the family home and the family's domestic 'phone line for occasional business calls and internet access there are no other financial, economic or organisational links between the two companies. Although Mr B's company could not survive organisationally or financially without use of the family home, there is no direct or indirect financial support from either his wife or his wife's company to either him or his company, and no organisational links which amount to substantial interdependence.

Y is the director and sole shareholder of Company A and Mrs Y is the major shareholder in Company B. The two companies operate a chain of hairdressing salons. Company A provides hairdressing services and Company B provides hairdressing products. Company A rents the premises, employs the stylists and receptionists and pays all the bills. There is no cross charge for the use of facilities. Credit card payments are accepted by the salons, the electronic swipe machines being in the name of Company A. There is a single bank account to which the swipe machines are attached. At the end of each day the bankings are split between the two companies and transferred to their main bank current accounts. The accounts of the two companies do not truly reflect the situation of the businesses but are just an artificial division. In reality the two companies are part of a single organisation – there is just the one business.

Z is the director and sole shareholder of Company P. He and his son are directors of Company Q, and own 50 per cent of the shares each. Companies P and Q run a builders' yard selling wholesale to the building trade and retail to the public from the same premises, which Z owns. Company P is the trade wholesaler and has a 'trade only' counter; Company Q sells retail at a counter with its own access and parking in the yard. Company P's buyer buys stock for both the wholesale and retail side but the product ranges, stocking levels and prices are different. There are separate 'phone lines for the wholesaler and retailer. Z charges Company P a commercial rental. At the end of each week Company P invoices Company Q for goods supplied at cost plus a small mark-up. There is a proportionate division of overhead costs and Company P invoices Q an additional charge for other facilities. Wages for common employees are split in proportion between the two businesses. There are separate sale terms and tills for the businesses and they operate separate bank accounts and credit and credit card facilities. Each business has its own vehicles and the costs are kept strictly separate. Where several business activities are operated from the same or adjoining premises, and the existence of one underpins the viability of the other, the companies will be interdependent. While the two companies may operate at arms length, there are significant organisational and economic links such that the retail business could not operate without the wholesale side. Accordingly, the companies will be associated.

Contributed by Gerry Hart

Lecture B619 (9.02 Minutes)

Value Added Tax

Supply of wedding reception facilities

The appellant owns premises which have been decorated to provide, so far as possible, the atmosphere of an Indian wedding. The appellant claimed to have been making exempt supplies of the letting of land; HMRC alleged that the appellant was making standard-rated supplies of catering or, if not, standard-rated supplies of wedding reception facilities.

The Tribunal considered first whether there was a single supply or separate supplies of various goods and services. It concluded that there was a single supply because all the supplies were so closely linked that it would be artificial to separate them.

The Tribunal concluded next, from the facts, that catering was not supplied by the appellant. Food was supplied by outside caterers and was supplied direct to the customer, not to the appellant for onward supply.

Supplied

The Tribunal then listed what was supplied by the appellant—

- the use of one or both of the halls in the appellant's premises, together with use of the reception area and lavatories; assurance from the appellant's director that he would take as much care over the wedding celebration as if it had been his own daughter's wedding;
- guidance to suppliers of food, flowers, live music, Indian dancers, and bridal outfitters (described by the Tribunal as hand-holding);
- liaison with caterers and other suppliers, arranging to give them access;
- the director's presence at the wedding, to introduce proceedings, to diffuse any arguments, to deal with illness;
- background music if there was no live entertainment;
- chairs and tables;
- occasional barrel or so of beer (particularly at Sikh weddings), or sometimes soft drinks;
- someone to serve behind the bar;
- someone to clean up;
- security staff; and
- displays of fruit.

Not supplied

The following were not supplied—

- waitresses and serving staff;
- DJs or live music;
- alcoholic drinks (save as noted above);
- flowers, dancers, music; or
- food.

Finding

On balance the Tribunal concluded that the appellant did far more than act as a passive provider of land. It provided to its customers the benefits of its management, supervision and maintenance of the premises (including the necessary cleaning and maintenance after one event in readiness for the next one), including help before and during events. For a typical customer, its activities went far beyond merely providing the key to a door.

The appeal was dismissed.

Best Images Ltd TC480

Reed Employment plc TC523

In the landmark case *CCE v Reed Personnel Services Ltd* [1995] STC 588 the High Court confirmed the Tribunal's decision that Reed had been acting as agent in supplying nursing staff, despite contracts which did not make the VAT position clear. This led Reed to make various other claims for VAT refunds, on the basis that it had wrongly accounted for VAT on other supplies of staff. HMRC allowed Reed's claims for 1993 to 1996 and then (when implementation of the three-year cap had been shown to be faulty) for 1991 to 1993. However, Reed's claim for 1973 to 1991 was not made until June 2003 and remained unresolved by this decision, which was part of the procedural preamble to an appeal hearing.

The delay in agreeing the 1973 to 1991 claim had been thought to concern three-year cap and unjust enrichment issues. When they were resolved in Reed's favour Reed expected HMRC to meet its claim but instead HMRC sought instead to refuse repayment on the basis that Reed had not proved the factual basis of its claim – by showing that it had in fact acted as agent in each of the cases in question.

Reed opposed HMRC's application to amend its statement of case to include the question of proof of agency. That issue had not been raised by HMRC until 2009. Previous claims had been met without any need to prove the detailed facts. Reed would have been able to provide documentary evidence in 1995, when the VAT principle had been confirmed by the High Court, but had since moved offices and had destroyed papers which were thought to be too old to be of use. Reed considered it unfair for HMRC to be allowed to amend its statement of case at this late stage, having led Reed to believe that retention of documentation would not be necessary.

The Tribunal understood the obvious prejudice to Reed if amendment of the statement of case were to be permitted; but also noted that HMRC would be prejudiced if amendment were refused, since the appeal would simply be allowed in full without Reed having to prove its case. The Tribunal's solution to this dilemma was to allow the amendment but to exhort the Tribunal which hears the appeal to take a generous view of the facts, perhaps extrapolating such evidence as can be brought to other, similar cases. The Tribunal said:

"… one or other party will be prejudiced whatever we decide. If the appeal proceeds the appellant will suffer from the considerable difficulty of providing evidence that might have been available 15 years ago. If it does not proceed the appellant will win and HMRC will have to make a repayment of some £4m without the appellant ever having proved its case on the merits, but on the other hand HMRC failed to plead agency in the original statement of case of 21 June 2004 and the case might have been decided on that basis. If it is necessary to do so we consider that the right balance would be achieved by allowing the appeal to proceed, so as not to allow the appellant to win without ever proving its case, but taking into account the additional difficulty now facing the appellant in providing evidence. We cannot tie the hands of the tribunal that hears the case but we express the hope that they will be ready to accept that the position relating to later years for which there is evidence will be applied to earlier years for which there is no evidence. Indeed this is exactly what HMRC did in relation to the 1991 to 1993 claim …"

RP Griffin and DM Griffin TC521

Mr and Mrs Griffin fell into cash flow difficulties when their public house business proved to be less successful than they had hoped. The Tribunal held that restrictions applied by their bank on their ability to borrow did not amount to a reasonable excuse. However, because an earlier default was excused by the existence of a time-to-pay agreement with HMRC, which Mr and Mrs Griffin had complied with fully, the surcharge rate for the default under appeal was 5%, not 10%. The appeal was thus allowed to that extent.

Comment: The above summary is not of great interest but comments of the Tribunal regarding the application of the (non-binding) decision in *Aardvark Excavations Ltd* 20468 do have a degree of significance. The Tribunal said:

"Mr and Mrs Griffin did not have a reasonable excuse for the late submission of the 08/08 return and the late payment of VAT for that period."

"However, we consider that by entering into and fully complying with a Time to Pay agreement Mr and Mrs Griffin had a reasonable excuse that would have enabled them to have successfully appealed against a liability to a surcharge arising as a result of the late submission of the 02/08 return and late payment of VAT for that period."

"The effect of a reasonable excuse for an earlier period for which no appeal was made on the amount of a surcharge under appeal and whether s 59(7) and (8), VAT Act 1994 prevents a tribunal from considering defaults other than the one directly occasioning the surcharge under appeal or one within s 59(8)(b) as regards the appealed surcharge was considered by the VAT and Duties Tribunal (Chairman Charles Hellier) in *Aardvark Excavations Ltd v HMRC* ("Aardvark"), which concluded at [58] that: "the tribunal is entitled to have regard in the application of s 59(7) to a *prima facie* default other than that directly giving rise to the surcharge under appeal for the purpose of determining whether such a default whose existence may affect the amount or existence of the default under appeal, may be ignored".

"[Counsel for HMRC] explained that, although there had not been an appeal, HMRC regarded the decision of the Tribunal in *Aardvark* as misconceived and submitted that it should not be followed in the present case."

"However, given the careful, detailed and thorough consideration of the relevant legislation in *Aardvark* (at [32–58]), we accept the 'wider approach' to the construction of s 59 and agree with the conclusion of the Tribunal.

"As such we consider that *Aardvark* should be applied in the present appeal."

"Having found that, by entering into and complying with a Time to Pay arrangement agreed with the Debt Management Unit of HMRC, Mr and Mrs Griffin had a reasonable excuse for the late submission of the 02/08 return and late payment of VAT the effect is that because they had a reasonable excuse for the 02/08 default the 08/08 default is to be computed as if the 02/08 default had never happened. Accordingly the rate for the 08/08 default is 5% and not 10%."

To summarise, then, HMRC did not agree with the decision in *Aardvark* but, instead of appealing, decided to ignore the decision and merely allege that it was wrongly decided if challenged on the matter. This presumably leaves practitioners with the responsibility of educating their clients as to the true state of the law. It is hard to see how it assists HMRC's argument that traders should be more vigilant about their appeals when HMRC may be said to be seeking to keep those traders in the dark about their rights.

VAT DIY builders scheme: technical note

This article reviews the purpose and operation of the VAT DIY builders scheme, and illustrates the problems of making a claim through Tribunal decisions over the last two years.

It is notable that there have been at least 14 cases in this area over that period: many professional advisers will be relatively unfamiliar with it because it is a relief claimed by people who are not in business, who therefore may not take professional advice. For that reason, it is not surprising that many of them do not succeed in appeals before the Tribunal – they may have a sense of righteous indignation about the way the rules have disadvantaged them, but no technical grounds to refute HMRC's refusal to make a repayment.

It is perhaps more surprising that several of the appellants have won, and their victories are interesting illustrations of the way the rules work.

Basic outline of the scheme

The DIY builders scheme is intended to provide equality of treatment for those who organise the construction of their own home with those who buy a house from a housebuilder. The reliefs which are available are:

- for the purchase from a housebuilder: building materials installed in the house will be subject to VAT when the builder buys them, but the sale of the house will be zero-rated under Sch.8 Group 5 VATA 1994, so the VAT on the materials is relieved;

- for the DIY builder: services in the course of construction of a dwelling should be charged at the zero-rate by contractors, and the non-business DIY builder can recover VAT on building materials under the DIY scheme (for which the authority is s.35 VATA 1994).

There are links between the two sets of rules: for example, the basic definition of what is a "dwelling" is found in Group 5, and is read through into s.35. However, there are important differences in the application of the rules and in their effect, for example:

- all a builder's costs (apart from materials which are not ordinarily installed in dwellings) will be eligible for relief under zero-rating, but a DIY housebuilder is likely to suffer VAT on services that do not qualify for either zero-rating or a DIY claim – in particular, the services of an architect;
- a builder who converts non-residential property into a dwelling and grants a major interest in the property can zero-rate the supply, relieving all the VAT cost – but a DIY builder will only be able to receive conversion services subject to the lower rate (5%) on a conversion, and so will suffer a VAT cost to that extent.

DIY claim forms

HMRC introduced two new claim forms for VAT refunds under the DIY housebuilders scheme with effect from 15 August 2009. One of the new forms deals with new houses and the other deals with conversions. The intention is that the guidance will be much clearer and there will be a reduction in the confusion of claimants, requirements by HMRC for further information, and disputes which have arisen in the past.

The old Public Notice 719 was withdrawn and replaced with dedicated guidance for each of the new claim forms. This is referenced as VAT431NB for new builds and VAT431C for conversions.

R&C Brief 45/09; SI 2009/1967

The essential conditions

The guidance notes should be consulted for the conditions in detail, but in outline they are as follows:

- the claim must relate to a project in which someone either constructs a dwelling or converts a non-residential building into a dwelling;
- this must not be related to any business purpose, which includes selling or letting out;
- the claim relates to eligible goods, which must be "building materials" within the meaning of Group 5 Note 22;
- the work must be carried out in accordance with planning conditions, but the planning conditions must not rule out the resulting building being a "dwelling" by prohibiting its separate sale or use;
- one claim is allowed per project, and it must be made within 3 months of the completion date;
- only the dwelling itself is covered, not further separate buildings or other items constructed afterwards – the only exception to this is a garage which is constructed at the same time as the dwelling itself.

There are a number of minor variations, including the separate scheme for claiming in respect of conversions, fitting out a shell which has been purchased from a builder, and constructing buildings for relevant residential or charitable use rather than own occupation.

The problems of meeting these conditions will be considered in the context of recent cases.

Qualifying building project

A DIY claim is only permitted for a new dwelling, not for an alteration to an existing building. It is permitted to retain part of a previous structure only if it is required as a condition in the planning consent.

An individual discussed a project to convert two old farm buildings with the planning officer, and was told that it would be unlikely to be accepted unless the façade was retained. He therefore

submitted plans that he thought would be accepted, and was granted permission that did not refer to the retention of the façade as a condition.

HMRC subsequently refused his DIY claim, and their decision was upheld by the Tribunal. The appellant submitted a letter from the planning officer stating that the application would probably have been refused if it had not retained the façades, but to satisfy the VAT law it had to be explicitly stated in the planning consent at the time.

First Tier Tribunal (TC0037): Roland Hall

A contrasting decision was reached by a different Tribunal soon afterwards. An individual demolished a house and constructed a new one, apparently doing nearly all the work himself. When HMRC refused his DIY builder's claim, he represented himself before the Tribunal and won. The question was whether the dwelling constructed was truly "new", because he had retained the façade and the eastern wall of the former building.

He argued that the eastern wall was a party wall, without which the neighbouring property would have collapsed. The Tribunal agreed with this contention. Chimney stacks could be regarded as part of the wall for this purpose.

He also argued that the retention of the façade was a requirement of his statutory planning consent. The building was historic and in a conservation area, and he had discussed the requirements with the planning authorities in some detail. HMRC said that the planning consent did not explicitly state that he was required to retain the façade, and they argued that it was not permitted – according to precedent case law – to look to other documents to explain or expand the contents of statutory planning consents.

The Tribunal allowed the appeal. The consent was explicit in requiring the work to be carried out in accordance with the plans that had been submitted. The plans showed that the façade would be retained. The Tribunal was in no doubt that the planning authority would have taken action against the individual if the façade had been destroyed. Even if the words were not used, the planning consent required the retention of the façade. The building therefore satisfied the conditions of Sch.8 Group 5 Notes 16 and 18 to be regarded as a new building and the DIY claim succeeded.

First Tier Tribunal (TC00132): Kevin Almond

Planning conditions

Another difficult case on a DIY claim was also decided in favour of HMRC's refusal. In this case the claimants had fitted out a flat in a block which had been converted from industrial premises into dwellings. Unknown to the claimants, the developer had contravened the terms of its planning permission and had to apply for retrospective approval of what it had done to the site; the work carried out by the claimants did not breach the original planning consents. Other occupants had claimed VAT and had it refunded.

During the processing of this claim, HMRC became aware that the original planning permission for the site had been withdrawn and a new consent had been issued. This meant that the work was not lawful at the time it was carried out, which breached the rules in s.35(1)(b) VATA 1994.

The Tribunal suggested that the appellants might have a case based on unfairness that could be taken up with the Revenue Adjudicator, but they did not have a case in law that could be supported by the Tribunal. The appeal was dismissed.

First Tier Tribunal (TC00539): Sam Bond and Sarah Baxter

Non-residential?

An individual obtained permission to convert a building which had been used as a garage and workshop into a dwelling. HMRC refused his claim under the DIY builders' scheme on the grounds that it did not qualify as a "residential conversion". Note 8, Group 8 Sch.8 VATA 1994 states that "*References to a non-residential building or a non-residential part of a building do not include a reference to a garage occupied together with a dwelling*". The individual argued that the building had in fact been an agricultural outbuilding rather than a garage, but HMRC contended that it had been used as a garage and therefore fell within Note 8. It was therefore not "non-residential" before the conversion work.

HMRC argued that the Tribunal had misdirected itself in law in two earlier similar appeals [*Cottam* (VTD 20,036) and *Blacklock* (VTD 20,171)]. However, the Tribunal distinguished the case from the facts of the earlier decisions, and instead accepted HMRC's main argument that the building had been in use at least partly as a garage. The appeal was dismissed.

First Tier Tribunal (TC00322): J Podolsky

Business or not business

An individual had been in business investing in and letting property for many years. He was not registered for VAT because he only made exempt supplies. He agreed with a long-standing friend to supervise the building of a cottage for the friend's disabled son. Once the building was completed, HMRC ruled that:

- the individual who built the house could not recover the VAT incurred on costs because the project was undertaken in the course of his business (and was therefore outside the DIY scheme) and he was not registered for VAT (so his a zero-rated supply of building services could not make him eligible for recovery);
- the person for whom the house was built could not claim under the DIY scheme because the materials which were the subject of the claim had been supplied to the builder, not to the customer.

The Tribunal accepted that HMRC were correct in their application of the law, but the chairman was struck by the unfairness of the result. Apart from examining the facts of the case in some detail to demonstrate that the conclusion was inevitable even if unwelcome, the chairman explored possible ways in which the VAT might still be recovered – mainly by the individual applying for retrospective registration (the appeal was approximately three years after the project commenced) which would entitle him to recover VAT on the invoices.

First Tier Tribunal (TC00155): WJ Terry t/a Wealden Properties

Held not to be business

An individual, who was a professional lecturer in sustainable architecture, arranged for the construction of two dwellings. She intended to live in one and let the other. She claimed back the VAT under the DIY builders' scheme: HMRC allowed half and refused to repay the rest, on the grounds that the letting of the flat would constitute a business.

The appellant advanced two grounds both of which had to be dismissed by the Tribunal: that she had relied on misleading advice from an officer she had spoken to on the phone, and that the zero-rating of new dwellings was "within the spirit of the legislation".

However, the Tribunal accepted her third argument, that the letting was not a business activity. The building was partly an academic project, putting her theories on sustainable architecture into practice, and to be used for research purposes. The costs were substantially higher than they would be on a normal property, and if she had expected to make a profit, she would have located the building in a more desirable place.

The Tribunal considered that her motive could not determine whether the activity was a business or not, and recognised that renting of immovable property is usually considered an economic activity. Nevertheless, there are exceptions, for example *Yarburgh Children's Trust*. The chairman recited the tests of "business" as set out in *Lord Fisher*, and concluded that one of the most important was not satisfied: the project was not "conducted on sound and recognised business principles". It was more concerned with the environmental and sustainability issues than with those of commerce. Looked at as a whole, the project was not commercial, and the DIY claim should be allowed on the whole amount.

First Tier Tribunal (TC00224): Paola Sassi

Statutory construction

An individual purchased materials to build a log cabin. HMRC disallowed a DIY claim on the basis that the planning permission prohibited occupation of the resulting property during February each year, so it was not a "dwelling" (Sch.8 Group 5 Note 13).

The individual appealed, arguing that Note 13 was not relevant to a claim under s.35. The judge agreed, commenting that Note 13 affected supplies within Item 1 of Group 5 (supplies of the

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constructed building) but not supplies within Item 2 (supplies of construction services). If a builder supplied construction services with materials, that would fall within Item 2, so the cost of the VAT in the materials would not be borne by the consumer. The judge decided that the interpretation of s.35 should not impose that cost on the DIY claimant when it could be avoided under Sch.8 Group 5.

It is curious that the judge felt that it was contrary to the intention of the legislation to impose a VAT cost where a DIY builder purchased labour and materials separately. That is a common result if an individual breaks the chain of supply by making separate purchases of goods and services. However, the judge appears to have been persuaded that there were many other similar log cabins on the same site, subject to the same planning restrictions, on which the VAT cost had been avoided by the builder supplying goods with services.

First Tier Tribunal (TC00362): Mrs IS Jennings

Following this Tribunal decision, HMRC have issued a Brief to explain their acceptance of the conclusion that the DIY housebuilders' scheme does allow recovery of VAT on building materials for holiday homes, if they are constructed by the claimant for a non-business purpose. HMRC will also accept claims which relate to conversion of non-residential property into a holiday home.

Claims for VAT previously incurred can now be submitted as long as the completion certificate is not older than four years and three months at the date of the issue of the Brief, 16 June 2010.

R&C Brief 29/2010

Simple mistakes by builders

A DIY builder reclaimed some £17,000 in VAT after converting a derelict cottage for himself to live in. HMRC repaid about £13,000 but refused the rest, stating that the builders should have charged only 5% VAT. The individual appealed to the Tribunal, apparently relying on a reading of the legislation that led him to the conclusion that only "relevant residential use" could qualify for the lower rate.

The Tribunal agreed with HMRC's basic contention – the builders had charged too much, and HMRC were not able to refund any more than the VAT that should have been charged. However, the Tribunal also found that some of the invoices should have in any case been standard rated, so found for the appellant to a small extent.

First Tier Tribunal (TC0064): Geoffrey Williams

A farmer contracted with some builders for the conversion of a disused barn into a dwelling house, and made a claim for repayment of VAT under the DIY builders' scheme. The builders charged 17.5% VAT on certain supplies which HMRC believed should have been charged at only 5%, and they refused to refund the difference under s.35. The Tribunal confirmed that this was the correct approach and dismissed her appeal.

Normally the advice to the individual in this situation is to go back to the builder and ask for a refund of the difference. Unfortunately, the project had started and then stopped for lack of funds, and by the time it was finished and the DIY claim submitted, the builders would have been out of time to recover their overpayments from HMRC because of the 3-year cap in s.80 VATA 1994. It appears that the farmer did not even try this route.

First Tier Tribunal (TC00287): SF Nike

A similar problem, and a similar decision, arose in a second case.

First Tier Tribunal (TC00413): Ian Robertson

An individual reclaimed VAT incurred on the construction of a new house. HMRC refused a large part of the claim, pointing out that it included services in the course of construction that should have been zero-rated. Many of the suppliers refunded the VAT on the basis of this ruling, but the individual was in dispute with two of the suppliers and received no refund.

He argued to the Tribunal that HMRC ought to refund the VAT because the claim form was misleading. It asked for details of "goods, materials and services", which implied that services could be included in a claim. That part of the form related to conversions of non-residential property, on which it is possible to claim for services which would not be zero-rated; there are now separate forms for new build and conversions in order to alleviate this problem.

The appellant also argued that the purpose of the DIY scheme was to put a self-builder in the same position as a developer. The refusal of his claim disadvantaged him.

The Tribunal had some sympathy for his situation, but it could only reject his appeal. It was clear that the invoices concerned zero-rated supplies, and they could not be included in a DIY claim.

First Tier Tribunal (TC00535): M O'Donnell

An individual bought a site in 1985, spent 9 years getting planning permission to construct a house on it, and finally occupied it 11 years after that in May 2005. A DIY builder's claim of £36,000 was restricted by HMRC to only £12,780. He appealed to the Tribunal, which agreed that the problem was that many of the invoices on which he claimed should have been zero-rated by the builders – they were for construction services with associated materials. It was not possible for the customer to claim back from HMRC VAT which should not have been claimed in the first place. The only recourse was to the builder.

This would of course present a problem for the builder, who could only adjust the VAT payable to HMRC in the last 3 years – although HMRC's representative pointed out that the builder could make a "*Fleming* claim" in respect of pre-1996 VAT if it was submitted by 31 March 2009.

VAT Tribunal (20,934): Dermot O'Reilly

Goods or services?

A similar problem, but with a more feasible solution, arose in another case. A couple building a house were required by planning regulations to install a sprinkler system on the ground floor. The installer charged VAT, and HMRC refused to repay it under the DIY scheme. The Tribunal agreed that the installation was a supply of services and should have been zero-rated; the couple would have to go back to the installer for a refund. As the installer company raised its invoice in January 2006, and the appeal was heard on 10 December 2008, there might just have been time within the three-year cap to sort out the VAT refund.

VAT Tribunal (20,948): P & M Bates

Goods with services

An individual submitted a DIY claim which included invoices for doors and windows which had been supplied in conjunction with zero-rated services. HMRC said that the goods should also have been zero-rated as "builders' materials" and refused to pay the DIY claim. The Tribunal agreed that the individual was not entitled to recover the money from HMRC: it had been overcharged by the builders.

First Tier Tribunal (TC00222): Michael Roy Culverwell

Contributed by Mike Thexton

Lecture B620 (24.35 Minutes)