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Personal Tax

Final Rules On Pension Contributions Tax Relief From 6 April 2011

Lifetime allowance

2010/11	£1.8 million
2011/12	£1.8 million
2012/13	£1.5 million

Annual allowance

2010/11	£255,000 (subject to anti-forestalling measures)
2011/12	£50,000

Contrary to expectations, tax relief is claimable at the individual's top rate as a deduction from income. Any excess contribution is subject to an annual allowance charge – the rate also found by taking the charge as the top slice of income.

Other changes from 6 April 2011

Under a defined benefits scheme the contribution value is 16 x the increase in the annual pension entitlement. This used to be 10 x.

Illustration 1:

Employee's salary £50,000; other income £20,000

25 years' service = pension accrued of 25/60ths of final salary = £20,833 pa, revalued by inflation (say 3%) to £21,458

Salary increase £10,000 = pension accrued of 26/60ths of final salary = £26,000 pa

Increase = £26,000 - £21,458 = £4,452

Contribution value = 16 x £4,452 = £72,672

Annual allowance excess charge = £72,672 - £50,000 = £22,672 @ 40% = £9,069

The total tax on the salary increase of £10,000 is £9,069 plus £4,000 (40% x £10,000) = £13*,069 which is an effective rate of 130%*

Illustration 2

Employee's salary £150,000

20 years' service = pension accrued of 20/60ths of final salary = £50,000 pa, revalued by inflation (say 3%) to £51,500

Salary increase £9,000 = pension accrued of 21/60ths of final salary = £55,650 pa

Increase = £55,650 - £51,500 = £4,150

Contribution value = 16 x £4,150 = £66,400

Annual allowance excess charge = £66,400 - £50,000 = £16,400 @ 50% = £8,200

The total tax on the salary increase of £9,000 is £8,200 plus £4,500 (50% x £9,000) = £12,700 which is an effective rate of 141%

Other points

If the annual allowance from 2011/12 is exceeded due to one-off "spike" in accrual under a defined benefits scheme, the excess can be set against any unused allowance from the previous 3 years (but in the earlier years the assumed maximum contribution is at the £50,000 level)

The annual allowance charge on an excess contribution will apply even in the year when pension benefits are drawn, except where the benefits are in the form of a serious ill-health lump sum.

The rate of an annual allowance charge is the "appropriate rate" and that is linked to the top slice of the individual's income so that it reflects the rate of relief given on the pension saving.

The lifetime value of a final salary entitlement continues to be determined by using a multiplication factor of 20. Protection is promised for those who have already exceeded the new lifetime limit of £1.5 million.

Purchasing an annuity

The low annuity rates inevitably on offer nowadays mean that for many individuals it is an unattractive proposition to take the 25% tax-free lump sum and then buy an annuity with the remaining 75% held in the fund. As an example, a 65 year old male with 3% pa escalation and 50% of the annuity payable to his widow, could have expected an annuity rate of about 11% in 1990. Just 20 years' later he could expect only 3.9%.

The Treasury say they are committed to fostering developments in the annuities market, and the likely structure is summarised below:

Pension investors are currently required to take pension benefits by the age of 75. The income can be provided either via an annuity or via income drawdown (unsecured pension) and then Alternatively Secured Pension (ASP) from age 75. Under the proposals, there will no longer be a requirement to take pension benefits by a specific age. Tax-free cash will still normally only be available when the pension fund is made available to provide an income, either by entering income drawdown or by setting up an annuity. Pension benefits are likely to be tested against the Lifetime Allowance at age 75.

The government plans to abolish Alternatively Secured Pension (ASP) which is similar to income drawdown, but has a more restrictive income limit, a requirement to take a minimum income and less flexible death benefits. Instead income drawdown can continue for the whole of retirement.

Currently, on death in drawdown before age 75 there is a 35% tax charge if benefits are paid out as a lump sum. On death in ASP a lump sum payment is potentially subject to combined tax charges of up to 82%. It is proposed these tax charges will be replaced with a single tax charge of around 55% for those in drawdown or those over 75 who have not taken their benefits. If you die under the age of 75 before taking benefits your pension can normally be paid to your beneficiaries as a lump sum, free of tax. This applies currently and under the new proposals.

For investors using drawdown as their main source of retirement income the rules will remain similar to those in existence now with a restricted maximum income. However for investors who can prove they have a certain (currently unknown) level of secure pension income from other sources, there will potentially be a more flexible form of drawdown available which allows the investor to take unlimited withdrawals from the fund subject to income tax.

Other proposals include extending the ability to take small pensions as cash using the "triviality" rules beyond age 75, allowing value protected annuities after this age and changing the tax charge on a lump sum from a value protected annuity to 55%.

For investors reaching age 75 after 22 June 2010 but before the full changes are implemented, interim measures are in place that broadly speaking apply drawdown rules and not ASP rules after age 75.

Any tax-free cash must still normally be taken before age 75 though there will be no requirement to draw an income. In the event of death any remaining pension pot can be passed to a nominated beneficiary as a lump sum subject to a 35% tax charge. These interim measures are expected to cease when the full changes are implemented.

Contributed by Gerry Hart

Lecture P621 (15.53 Minutes)

HMRC Toolkit: Property Rental

Introduction

This toolkit provides guidance on the errors that HMRC find commonly occur in relation to property rental and the steps that you can take to reduce the risk of those errors. Its use is entirely voluntary.

The toolkit should be used for financial years commencing 6 April 2009 for Income Tax Self Assessment Returns. It will be updated each year to reflect any changes.

1. Have all gross rents and other receipts from land and property been included as property income?

Risk

Land and property income includes all gross rents received before any deductions, for example property management fees. Income also includes other receipts such as grants, ground rents etc.

Mitigation

Ensure that all property income is identified and includes all rents gross of any fees or expenses paid. Identify any ancillary receipts and ensure these are also included as property income.

2. Have any deposits received been included as income as appropriate?

Risk

Deposits taken from tenants should be recognised in accordance with generally accepted accounting practice, normally by being deferred and matched with the costs of providing the services or carrying out repairs. Bonds are generally not rental income and are held separately. Deposits not refunded at the end of a tenancy or amounts claimed against bonds should normally be included as income unless they have already been recognised.

Any deposit balance not used to cover the cost of services or repairs and that is repaid to the tenant or licensee should be excluded from the receipts of the rental business.

Mitigation

In accordance with generally accepted accounting practice, deposits should normally be deferred and matched with the costs of providing the services or carrying out repairs. Review the deposits and bonds held and ensure that they have been included as income where appropriate.

3. If a jointly owned property is let, has the profit or loss been divided correctly?

Risk

Where two or more individuals jointly own a property any profit or loss is normally divided between them according to their share of the property being let unless a different division is agreed. The share for tax purposes must be the same as the share actually agreed.

Where the joint owners are married or in civil partnership, the profits or losses should be split 50/50 unless they own the property in unequal shares and they make an election to have their share match the share they each hold.

Mitigation

Establish if rents have been received from a jointly let property. Ensure that the share of the profit or loss shown on the tax return is divided between the owners according to their share of the property unless a different division has been agreed between them.

Where the individuals are married or in a civil partnership ensure the profit or loss is split 50/50 unless an election is made for their share to match the share of the property they each own.

4. Have overseas rental profits / losses been treated correctly as income of an overseas property business?

Risk

Profits or losses of an overseas rental property should not be combined with those of a UK rental business. If profits or losses of the UK and overseas rental businesses are combined this may result in

profits or losses being calculated incorrectly, for example if the losses from one are set against profits of the other. Special rules may apply to the commercial letting of furnished holiday accommodation in the European Economic Area (EEA), refer to Q5

Mitigation

Ensure that all income and expenses declared on the UK property pages of the return relate to UK properties and that any income and expenses relating to overseas property are declared separately on the foreign pages. Ensure that the losses of one business are not set against profits of the other business.

5. For furnished holiday lets, have all qualifying conditions been met?

Risk

Special tax rules allow the commercial letting of furnished holiday accommodation in the UK to be treated as a trade for some specified purposes, including loss relief, capital allowances and certain capital gains reliefs. From 2009 the rules have been extended to include FHLs of accommodation elsewhere within the EEA.

All of the following qualifying conditions must be met.

Mitigation

Ensure that the property is situated in the UK or elsewhere in the EEA, furnished, let on a commercial basis, with a view to a profit, and that all qualifying conditions are met. Ensure all furnished holiday letting income is included on the UK property pages.

6. If surplus business premises have been let, and the rent receivable treated as a business receipt have all of the conditions been met?

Risk

Rent received from letting surplus business accommodation is strictly assessable as property income but may be included in the calculation of the businesses trading profits if certain conditions are met.

Mitigation

Establish whether rents have been received from letting surplus business accommodation. Ensure the conditions are met before including the rents in the calculation of trading profits.

7. Have all items of expenditure on the improvement of an asset been treated correctly?

Risk

When work is carried out to an existing or newly acquired property which results in the asset being altered, improved or upgraded - that is makes it better than it had been before, then such costs are normally capital and should be disallowed in computing the rental profit or loss for tax purposes.

Where any unintentional improvement arises due to the use of new materials, which are broadly equivalent to the old materials, the cost normally remains revenue expenditure. For example, replacing lead pipes with copper or plastic pipes.

Mitigation

Where work is carried out to repair or refurbish a new or existing property, review the expenditure to identify any items that represent improvements rather than repairs. Ensure that the relevant expenditure is allocated appropriately.

Where there are essential repairs made to a newly acquired derelict or run down property, see Q9.

8. Have any legal and other professional fees incurred in acquiring an asset been allocated appropriately?

Risk

Generally, fees are capital if they relate to a capital matter, such as the purchase of property. Therefore costs incurred in respect of acquiring, adding to or selling an asset are normally capital, for example fees paid to a surveyor/valuer, planning permission or registration of title on a property purchase.

The incidental costs of obtaining finance that are wholly and exclusively incurred for the purpose of acquiring the property are normally allowable.

Mitigation

Consider whether any legal or other professional fees have been incurred relating to property. Ensure that these costs are allocated appropriately.

9. Has all expenditure on essential repairs to a newly acquired property been treated correctly?

Risk

If a property is acquired in a derelict or run down state and the price paid for the property was consequently substantially reduced, expenditure incurred in repairing it and putting it into a fit state for letting or use in the business may be capital rather than revenue expenditure.

Mitigation

Consider the timing and extent of the work carried out on the newly acquired property and any relevant additional factors (see examples below). Ensure any expenditure incurred on repairing the property is allocated appropriately.

10. If pre-trading rental business expenditure has been claimed have all of the conditions been met?

Risk

The business normally begins when the letting of the first property begins. Expenditure incurred prior to the commencement of a rental business is allowable if it is incurred wholly and exclusively for the purposes of the rental business and it is not capital expenditure.

Qualifying pre-commencement expenditure is treated as incurred on the day on which the rental business commences.

Mitigation

Consider any expenditure on activities that are preparatory to letting. Ensure the expenditure meets the conditions noted.

11. Have any capital repayments been excluded from loan interest and other finance charges?

Risk

Only the loan interest is an allowable deduction in computing the rental profit or loss for tax purposes.

Mitigation

Review the mortgage/loan statements and separate the capital repayments from the interest payments. Ensure that only the loan interest payable in respect of the let property is included in computing the rental profit or loss.

No deduction should be made where Rent a Room Relief is being claimed during a year.

12. Have 'dual purpose' expenses been apportioned for any property used only partly for rental business?

Risk

Where any expenses are in respect of a property that is used partly for the rental business and partly for private or non-business, expenditure should be apportioned accordingly.

Expenditure relating to life insurance policies (for example a mortgage protection policy) on business loans and mortgages is not wholly and exclusively for the purposes of the business, and therefore is not an allowable deduction against rental income for tax purposes. The incidental costs of arranging business finance are normally allowable but the cost of monthly life insurance premiums are not.

Mitigation

Establish the amount of any non-rental business related expenditure and ensure that this is excluded in computing the rental profit or loss. A review of payments made to financial institutions may identify non-business payments, for example life insurance premiums.

13. If a vehicle has been used by a landlord, has only the business travel been claimed?

Risk

If a vehicle is used by a landlord for rental business and non-business travel, the full amount of any running costs, including fuel, insurance, etc paid by the business/landlord may not be wholly and exclusively for the purposes of the rental business. If the costs are not properly apportioned to reflect the business/non-business elements, the deduction claimed will be inaccurate.

Where the business is administered from an office outside the landlord's home, non-business travel will normally include journeys between home and office or let property.

Mitigation

Ensure there is an adequate record keeping system maintained to establish the proportion of business use each year. Apportion any costs to reflect the business/non-business elements and ensure only the business element is allowed.

14. Are expenses claimed only for business trips wholly and exclusively for the rental business?

Risk

If a trip either within the UK or abroad is for a mixed purpose the whole expense of the trip may not be allowable. If the sole purpose of the trip is for the rental business the expense will usually be allowable in full notwithstanding any incidental private benefit.

Mitigation

Consider the purpose of the trip. For example check whether there was any personal travel included within the trip or if the landlord was accompanied by their spouse/partner and/or family. Where the trip was not solely for the purposes of the rental business ensure the appropriate expenses, for example flights etc, are disallowed.

15. Where wages and salary costs are being claimed, have employment taxes been applied appropriately?

Risk

Operation of tax under PAYE and NICs can be overlooked where an individual other than the proprietor is employed full time or part time to collect rents, provide office assistance, gardening etc.

Mitigation

Where an individual is employed within the rental business, ensure that PAYE and NICs are operated appropriately on any payments made and these are remitted to HMRC.

Ensure that no deduction is made in computing the rental profit or loss for any drawings paid to the proprietor or partner, including any payment for time spent managing the property.

16. Are wages or salaries paid to relatives or connected parties commensurate with their duties?

Risk

Where there is a non-business purpose to wages and salaries paid, for example to relatives or connected parties or where the level of payment is determined by the relationship, then the part or proportion of the payment that is not wholly and exclusively for the purposes of the rental business is not an allowable deduction.

In addition if wages or salaries are not paid within nine months of the end of the period of account they should be disallowed.

Mitigation

Establish whether any wages or salaries were paid to relatives or connected parties. Confirm the payments were wholly and exclusively for the purposes of the rental business, for example ascertain the work done and reason for the payment.

Consider whether the wages or salaries paid to the individual exceed a reasonable level of reward for the value of the work undertaken i.e. the commercial rate. Ensure the overall remuneration package

including salary, wages, benefits and pension contributions is taken into account when considering whether the amounts were paid wholly and exclusively for the purposes of the rental business.

17. If a property has been let rent free or at less than normal market rate has any expenditure been restricted accordingly?

Risk

Unless a normal market rate is charged for a property it is unlikely that the expenses of the property will be incurred wholly and exclusively for business purposes and should normally be excluded from or restricted in computing the rental profit or loss.

If the business lets a property below the market rate as opposed to providing it rent free they can deduct the expenses of that property up to the amount of rent received. As a result uncommercial lettings should not produce a loss for tax purposes. Any excess expenses cannot be set against profits from another rental property or carried forward to be used in a later year.

Mitigation

Ensure that all expenditure relating to any property let rent free or below the market rate is excluded from or restricted in the accounts appropriately. Ensure that, for tax purposes a loss is not produced for any uncommercially let property.

18. If Wear and Tear Allowance has been claimed has it been calculated correctly?

Risk

When letting residential furnished property (excluding furnished holiday lettings), plant and machinery capital allowances cannot be claimed on furniture, furnishings or fixtures within the property. Instead a deduction can be claimed for Wear and Tear Allowance or Renewals Allowance.

Where the proprietor also lets unfurnished property Wear and Tear Allowance should be calculated on only the net rents from the furnished property.

Mitigation

Wear and Tear Allowance is not available where the property is treated as furnished holiday lettings because plant and machinery capital allowances may be claimed as if the activity were a trade.

Ensure that the costs of replacing plant and machinery within the rental property have not been claimed separately in addition to Wear and Tear Allowance.

Establish whether rental income is being received from any unfurnished lettings or from partly furnished accommodation. If so, ensure that this income is excluded when calculating the Wear and Tear Allowance.

19. If Rent a Room Relief is being claimed does it meet the conditions for relief?

Risk

Under the Rent a Room Scheme a qualifying individual can be exempt from Income Tax on profits from furnished accommodation in their only or main home if the gross receipts, before expenses, are less than the exemption limit. But they cannot then claim any of the expenses of the letting.

Unfurnished lettings and rooms let as an office or for other business purposes, for example storage, do not qualify. The scheme does not apply to companies or partnerships. Neither does it apply if the home is converted into separate flats that are rented out.

Mitigation

Ensure the individual is in receipt of rents from letting furnished residential accommodation in their only or main home and that the gross receipts, before expenses, are below the exemption limit.

20. Has excess Rent a Room income been treated as taxable rental income and the appropriate method applied?

Risk

The Rent a Room Scheme provides two methods to calculate the taxable profits when gross receipts exceed the exemption limit. If receipts in excess of the exemption limit are overlooked or one of the two methods is not applied the rental profits may be incorrect.

Mitigation

If the gross receipts exceed the exemption limit ensure one of the methods below is used to calculate the profits.

Method A: profits are calculated in the same way as for any property business. Total gross receipts are added together and allowable expenses are deducted appropriately.

Method B: profits are calculated by taking gross receipts and deducting the exemption limit. When this method is used the individual cannot claim any other expenses.

Method A will apply automatically unless an election is made to apply method B.

Once method B has been chosen it continues to apply unless the individual informs HMRC, within the time limits, that they would like the first method to apply again.

21. Has the 5 April basis period been applied?

Risk

For Income Tax purposes a rental business basis period is to 5 April each year. If the accounts are not drawn up to 5 April then the two sets of accounts drawn up to some other accounting date should be apportioned to establish the profit or loss for the year ended 5 April.

Mitigation

If accounts have not been drawn up to 5 April ensure profits or losses for the two years are apportioned on a daily basis to find the profit or loss for the relevant tax year.

22. Have rental business losses been used correctly and set in full against the first available rental profits?

Risk

Where rental losses are carried forward they must be used in full against the first available rental business profits. There is no provision that allows for a smaller amount to be relieved.

Losses made in one rental business cannot be set against any other rental business that is carried on at the same time in a different legal capacity.

Mitigation

Ensure that the correct loss figure is bought forward and fully utilised against the first available rental business profits. Where rental businesses are carried on at the same time in different legal capacities ensure that losses made in one rental business are not set against any other rental business.

23. Have only appropriate rental business losses been set against general income?

Risk

Property rental business losses should normally be carried forward and deducted from future profits of the same rental business. Losses can only be set against general income in limited circumstances, when they are attributable to certain capital allowances, certain agricultural expenses or furnished holiday lettings.

Mitigation

Where property rental business losses are to be set against general income, ensure that these are limited as detailed above and restricted appropriately. Ensure a claim is submitted within the appropriate time limit.

24. If a landlord is non-resident has tax been deducted from the rental payments?

Risk

Where the owner of a property usually lives outside the UK and is non-resident for tax purposes their letting agent or tenant should normally deduct basic rate Income Tax from the rental paid to the non-resident landlord.

Mitigation

Establish whether any rents are being paid to or received by a non-resident landlord. If so, ensure the landlord receives a certificate showing the tax deducted by the letting agent or the tenant.

For letting agents or tenants unless either of the exceptions apply, ensure that basic rate Income Tax has been deducted and paid to HMRC and a certificate of tax deducted is provided to the landlord by 5 July following the end of the year to 31 March.

25. If box 19 in the property pages of the SA return has been completed have the correct figures been included at box 18?

Risk

Where tax has been deducted from, for example a non-resident landlord's UK rents, the amount of tax deducted should be shown at box 19. No other amounts should be included in this box. The gross amount of income, the total amount received plus the tax deducted should be entered at box 18.

Mitigation

For non-resident landlords confirm that a tax deduction certificate has been received detailing the tax deducted by the UK letting agent or tenant. The amount of tax deducted should be entered at box 19. No other amount should be included in this box. Ensure the correct amount is included at box 18.

26. If there has been a disposal of a rental property has Capital Gains Tax been calculated appropriately?

Risk

Where a let property has been disposed of, Capital Gains Tax can be overlooked.

Mitigation

Identify any let properties disposed of and ensure that Capital Gains Tax is calculated and reported on the Capital Gains Tax pages of the tax return.

Ensure previous documentation relating to the purchase of the property and any capital expenditure are retained. This will ensure that the correct expenditure and reliefs are claimed in the Capital Gains Tax computation.

Lecture P622 (28.37 Minutes)

Pre-letting costs

The following readers query appeared in Taxation on 20 October 2010.

I have an elderly client who has had to go into a nursing home. Her family decided that the best course of action would be to rent out her home to provide an income which could then be used to help pay the nursing home fees.

However, the estate agents advised that before her bungalow could be let, it would have to be completely modernised and brought up to date.

The costs of refitting the bathroom, kitchen and central heating are, I assume, not allowable.

However, a lot of the costs were of a repair nature, i.e. decorating, retiling the bathroom and kitchen, gutter clearance, boiler service and safety certificate, roof repairs and rewiring of the electrical circuits and supply.

Are any of these pre-letting costs available to offset for tax purposes against the subsequent rental income?

Query 17,684 – Smartie

Reply from Graham Wilde, TaxNetUK Ltd

Expenses incurred within seven years of the commencement of the letting should be deductable on the first day of the letting if incurred wholly and exclusively for the purposes of the letting business – ITTOIA 2005, s 57.

So any repairs carried out before the letting starts can still be deducted from the first year's gross rents (see PIM2505).

In Smartie's case, the costs listed '... of a repair nature ...' should all be allowable as the client is now in a nursing home so the costs relate to preparing the property specifically for the letting, not incurred to improving her home while she was still in residence and could benefit personally.

Furthermore, Smartie's assumption regarding the non-allowability of the cost of refitting the bathroom, kitchen and central heating is not necessarily correct. So long as there is no element of improvement, then a replacement of these elements should normally be allowable against rents. HMRC detail their views on this point at PIM2020, in the final few paragraphs, and actually mention the replacement of a kitchen as an example.

They go on to say that where modern items are used (because the item being replaced may, through age, simply be no longer available or standard construction techniques and materials have simply progressed) so long as it is the nearest modern equivalent to the item replaced that is used, even though it may technically be an improvement, they will still allow it as a revenue item; e.g. a double-glazed unit replacing a single-pane window.

As an aside, for financing the costs of the refurbishment or simply to withdraw funds for the client, this can be achieved by raising a loan against the property.

Regardless of the actual purpose of the loan, all the loan interest would be allowable as a deduction against rents, on any loan where the loan value is no greater than the value of the property when first let out – see BIM45700, example 2.

In addition, this debt would reduce the net inheritance tax value of the asset in the client's estate, which may be seen as an additional advantage by Smartie's client.

Hankinson v Revenue and Customs Comrs

Section 29 of the TMA 1970 provides, so far as material: [(1) If an officer of the Board or the Board discover, as regards any person (the taxpayer) and a [year of assessment]— (a) that any [income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax,] have not been assessed ... the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which ought in his or their opinion to be charged in order to make good to the Crown the loss of tax ... (3) Where the taxpayer has made and delivered a return under [section 8 or 8A] of this Act in respect of the relevant [year of assessment], he shall not be assessed under subsection (1) above— (a) in respect of the [year of assessment] mentioned in that subsection; and (b) . . .in the same capacity as that in which he made and delivered the return, unless one of the two conditions mentioned below is fulfilled. (4) The first condition is that the situation mentioned in subsection (1) above is attributable to fraudulent or negligent conduct on the part of [was brought about carelessly or deliberately by] the taxpayer or a person acting on his behalf. (5) The second condition is that at the time when an officer of the Board— (a) ceased to be entitled to give notice of his intention to enquire into the taxpayer's return under [section 8 or 8A] of this Act in respect of the relevant [year of assessment]; or (b) informed the taxpayer that he had completed his enquiries into that return, the officer could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the situation mentioned in subsection (1) above ... (8) An objection to the making of an assessment under this section on the ground that neither of the two conditions mentioned above is fulfilled shall not be made otherwise than on an appeal against the assessment ...'.

In a tax return submitted to the respondent Revenue and Customs Commissioners (the Revenue) in respect of the tax year 1998–99 (the return), the appellant taxpayer indicated, inter alia, that: (i) he was not resident and not ordinarily resident in the UK and did not intend to live outside the UK permanently; (ii) he had spent 56 days in the UK in the past year; and (iii) that he had been employed abroad, full-time, for the entire 1999 tax year. On that basis, he submitted that all the income for that tax year was excluded income. In January 2005, following the collection of additional information pertaining to the taxpayer's circumstances in the tax year 1998–99, the Revenue made an assessment for income and capital gains tax for that tax year, purportedly pursuant to s 29 of the TMA 1970. The assessment was in the aggregate sum of over £30m. The taxpayer appealed against the assessment to the first-tier tribunal on the ground that, inter alia, the assessment had not been lawfully made. The tribunal found, and the taxpayer accepted, that the additional information obtained by the Revenue constituted a "discovery" within the meaning of s 29(1) of the Act (see [5] of the judgment). The tribunal proceeded to consider s 29(3) and (5) of the Act and

concluded that, on the basis of the information provided by the taxpayer in the return, an officer of the Revenue could not reasonably have been expected, at the relevant time, to have been aware of the insufficiency in the return. Although the tribunal decided that no more than that was necessary for the Revenue's assessment to be valid, it also considered s 29(4) of the Act. It concluded that that condition was also fulfilled, in that the taxpayer had been negligent in not making full disclosure of certain material facts. In the result, the tribunal dismissed the taxpayer's appeal, whereupon he appealed to the Upper Tribunal.

He contended that the tribunal's findings of fact were not sufficient to support its conclusion. Further, he submitted that the officer should have, but had not, considered whether the conditions in s 29(4) and (5) of the Act had been fulfilled before making the assessment and, as a result, the assessment was fatally flawed.

(1) The phrase "he shall not be assessed" as it was used in s 29 of the Act meant "he shall not be validly assessed". Accordingly, if one or both of the conditions set out in s 29(4) and (5) of the Act was fulfilled, the assessment was valid; if neither of them was fulfilled, the assessment was invalid. The subjective opinions of the assessing officer or the Board about fulfilment of the conditions had no part to play in the operation of s 29 (see [23] of the judgment).

That was the only conclusion which was consistent with s 29(8) of the Act: the subject matter of an appeal was whether or not either of the conditions was fulfilled, without any form of qualification. Further, on such an appeal, the tribunal would be entitled to take into account all the evidence then available in deciding whether one or other of the conditions was satisfied at the time of the assessment. Thus, if an assessment was made because the officer had made a discovery and also considered that the taxpayer was negligent, but later discovered clear evidence of fraud, there was no reason why reliance should not be placed on that clear evidence in resisting an appeal. That approach emphasised the objective nature of the tests in s 29(4) and (5) of the Act and demonstrated again that what was important was whether at least one of the conditions was fulfilled and not whether the officer thought that it was (see [23], [28] of the judgment).

In the instant case, the tribunal had come to the right conclusion for the right reasons: it had concluded that a discovery had been made and that the conditions set out in s 29(4) and (5) of the Act had both been fulfilled. Those were findings of fact which were not susceptible to challenge before the Upper Tribunal (see [29] of the judgment).

Vickerman (Inspector of Taxes) v Mason's Personal Representatives [1984] 2 All ER 1 applied; *R v IRC, ex p Newfields Developments Ltd* [2001] All ER (D) 282 (May) distinguished.

14 October 2010

Classification of investment income

The following query was raised in Taxation Forum on 27 October 2010

My client is now on his third stockbroker in four years. The stockbroker always holds the investment portfolio as nominee.

On comparing the 2009/10 tax report of the current broker with those of the two earlier brokers a problem is apparent.

The first broker categorised one particular investment as 'UK fixed-interest stock' and reported the income received as UK interest (paid gross) on a UK corporate bond.

This was consistent with his contract note that showed accrued interest being purchased.

The second broker categorised the same security as 'foreign stock' and reported the income received as foreign interest paid with no deduction of foreign or UK tax.

The current broker categorised the investment as 'UK equity' and reported the income as a UK dividend with a corresponding tax credit.

For the three years in point, the effective tax rates would be 40% of the interest received, but 25% of the dividend received.

The SEDOL number on the purchase contract note enables an internet search to reveal the company's issue prospectus for this security.

The issuing company is Barclays Bank plc (incorporated in England) and the full title of the security is:

> '6% non-cumulative callable preference shares'.

The prospectus expressly refers to dividends being paid. The security is issued in the form of bearer shares and is listed on the Luxembourg Stock Exchange.

Which of the above stockbrokers has the correct treatment?

Can I justifiably override the consolidated tax voucher issued by the two earlier brokers and make an error/mistake claim under TMA 1970, s 33 for the income to be taxed as dividends?

Is it the company's country of incorporation that determines whether the dividends and interest it pays are 'foreign'? The second stockbroker recorded the foreign interest as having a Luxembourg source.

To what extent can tax return preparers rely on a stockbroker's tax report and consolidated tax voucher?

Query 17,691 – Wrangler

Reply from ANA

It is normal when preparing a tax return to rely on stockbrokers reports for investment income.

However they are not infallible and in this case it appears that an error has been made.

Whether or not income has a UK source depends on all the facts of the case and on exactly how the transactions are carried out.

In the case of *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* (1971) 46 TC 472, a number of factors were listed in determining the source of income (interest in that case).

These include the residence of the debtor and the location of his/her assets, the place of performance of the contract, the method of payment, the competent jurisdiction for legal action and the proper law of contract, and the residence of the guarantor and the location of the security for the debt.

HMRC consider the residence of the debtor to be most important because this, along with the location of the debtor's assets, will influence where the creditor will sue for payment of the interest and repayment of the loan.

In this case, it is clear from the prospectus that the securities are equity not debt and the issuer is Barclays Bank plc, a UK company.

The fact that the shares are listed on the Luxembourg stock exchange does not change the residence of the company.

There should be no problem in making an error or mistake claim and reclaiming tax.

Wrangler will need to manage his client's expectations around this issue. As an error has been made in the tax return, it is likely that the client will blame his tax adviser.

Wrangler should advise his client of the situation and make clear that the error was made by the stockbroker rather than by him.

Reply from Terry 'Lacuna' Jordan, BKL Tax

It seems that Wrangler's client's predilection for changing his stockbroker has highlighted the incorrect classification of income in previous tax years that would presumably otherwise have gone unnoticed.

The income tax treatment must follow what the instrument actually is rather than what any individual stockbroker thinks it is (or classifies it as, perhaps without thinking).

In this case, the prospectus is key and, from Wrangler's description of '6% non-cumulative callable preference shares' issued by Barclays Bank plc, the payments are dividends from a UK company and happily this provides the most favourable result.

In the good old days, it might have been possible to telephone the relevant inspector and agree a simple compensating adjustment in the current year's tax return, but that is not likely to be a practical approach nowadays.

It will be appropriate for Wrangler to make an error or mistake claim under the provisions of TMA 1970, s 33 and Sch 1AB within the new time limit of four years after the end of the relevant tax years.

So far as relying on a stockbroker's tax report and consolidated tax voucher is concerned, there is a requirement to make a declaration that the tax return is to the best of the taxpayer's knowledge 'correct and complete' under TMA 1970, s 8(2).

The writer suspects that few, if any, advisers would feel it necessary to run checks on a stockbroker's report unless, as in this case, an anomaly has been highlighted.

Taxation Forum, 27 October 2010

Changes to capital relief against income

HMRC have published Revenue & Customs Brief 41/10 explaining a change in practice on relief against income for capital losses made on shares subscribed for in qualifying trading companies under ITA 2007, s 131 to s 151.

This change applies where individuals subscribe for a joint holding of shares, or subscribe for shares through a nominee.

If an individual subscribes for shares where enterprise investment scheme (EIS) income tax relief is attributable to those shares, or they are shares in a qualifying trading company, and makes a loss on the disposal of those shares, he can claim to set off that loss against income rather than capital gains.

Section 250 permits income tax relief where the subscription was made by a nominee on behalf of the individual, or where the subscription was made on behalf of joint owners.

Where EIS income tax relief was not attributable to the shares there is no equivalent legislation to extend relief to subscriptions by nominees or joint owners.

Previously, HMRC took the view that share loss relief for such subscriptions was available only where an individual personally subscribed for shares as a sole subscriber; relief was not considered to be available for subscriptions made in joint names, e.g. a married couple, or by a nominee.

The department has reconsidered its practice and will now accept claims to relief for losses on the disposal of qualifying shares where the subscription is made in joint names or through a nominee.

The proportion of the capital loss to be attributed to each joint owner needs to be determined as a question of fact, typically based on each owner's contribution to the cost of the shares.

Claims for share loss relief must be made within one year from the normal self-assessment filing date for the year in which the loss occurs.

This means that claims can still be made for share loss relief in respect of joint subscriptions or subscriptions through nominees for 2008/09 and later years.

In addition where there is an open enquiry into an existing claim to share loss relief for any tax year, including years before 2008/09, that claim can be settled in accordance with this change of practice.

HMRC will update the guidance in their *Venture Capital Manual* at VCM45000 et seq to reflect the new practice.

Revenue & Customs Brief 41/10

Capital Gains Tax

CGT and entrepreneurs' relief – a summer of change

As is now well known, the CGT rate stayed at 18% for 2010/11 following the Budget on 24 March 2010, with the annual CGT exemption unchanged at £10,100. It had been widely predicted that Alistair Darling would be forced to close the 32% gap between the top income tax rate for 2010/11 and the CGT rate, but this did not initially materialise.

Another unexpected announcement was the doubling of the entrepreneurs' relief limit for qualifying disposals made on or after 6 April 2010 (S4 FA 2010). Subject to certain conditions being satisfied, individuals can claim this relief in respect of gains on the disposal of trading businesses which they run, either alone or in partnership, or of shares in a trading company (or the holding company of a trading group). Where shares are involved, there is a proviso that the individual is an officer or employee of the company (or group) with at least 5% or the ordinary share capital and voting rights. Gains qualifying for relief were originally charged to tax at an effective rate of 10% through the simple expedient of reducing the gain by a factor of 4/9ths and then applying the 18% charge.

Following FA 2010, the increase to a new limit of £2,000,000 applied to gains arising on or after 6 April 2010. Thus, if a taxpayer made qualifying gains before that date of, say, £1,400,000, the amendment did not give relief for the £400,000 which fell outside the old limit. However, if the same individual then made another business gain of £750,000 on 1 June 2010, that gain would be fully eligible for relief and a further tax break of £250,000 would still have been available.

However, in the Coalition Government's first Budget on 22 June 2010, significant changes to the CGT system were announced by the new Chancellor. These comprised:

- an increase in the CGT rate to 28% with effect from 23 June 2010 in certain circumstances;
- a further rise in the limit for entrepreneurs' relief to £5,000,000, also from 23 June 2010 onwards; and
- a modification in the way in which the new entrepreneurs' relief is given.

These amendments have been legislated in S2 and Sch 1 F(No2)A 2010.

The revamped CGT rates

Para 2 Sch 1 F(No2)A 2010 replaces S4 TCGA 1992 which previously provided that all gains were chargeable to tax at a flat rate of 18%. This change takes effect for gains arising on or after 23 June 2010.

By virtue of new S4(2) – (4) TCGA 1992, it is provided that the rate of CGT is 18%, but that 28% applies to:

- trustees;
- personal representatives of deceased persons; and
- individuals liable to income tax at higher and additional rates

It should be noted that, where an individual's taxable income for a tax year is less than his basic rate band (currently £37,400), gains up to the amount of the unused portion of the band are charged at 18%. Gains above that limit are charged at 28% (S4(5) TCGA 1992). Gains which are eligible for entrepreneurs' relief are treated as utilising any unused part of the individual's basic rate band in priority to other gains (S4(6) TCGA 1992) – this prevents taxpayers maximising the benefit of any unused basic rate band for gains which might otherwise be taxed at 28%.

Para 3 Sch 1 F(No2)A 2010 inserts a new S4B TCGA 1992. This section, which has effect for 2010/11 onwards, provides that a person whose gains for a tax year are chargeable to CGT at more than one rate may now deduct any allowable losses and his annual CGT exemption in the most favourable order, ie. in the way which produces the lowest possible tax charge. This will normally involve losses and the annual CGT exemption being deducted:

1. first from gains (other than gains qualifying for entrepreneurs' relief) arising on or after 23 June 2010 which are chargeable at 28% or 18%;
2. then from gains arising between 6 April 2010 and 22 June 2010 (inclusive) which are chargeable at the old single 18% rate (this includes gains qualifying for entrepreneurs' relief which have been reduced by 4/9ths); and
3. finally from gains arising on or after 23 June 2010 which qualify for entrepreneurs' relief and are chargeable at the new 10% rate (see (j) below).

Illustration 1

Tom, who is aged 37, has a salary of £28,000 for 2010/11. He has no other income for this year.

On 15 April 2010, he realised a gain of £52,000 from the sale of an investment property. On 15 July 2010, he made a further gain of £95,000 from the sale of a holiday home which he had inherited some years earlier.

What is the tax charge on Tom's two gains?

Gains made before 23 June 2010 are automatically taxed at 18%. This rate will apply to the gain of £52,000.

In relation to his gain of £95,000 which arose on 15 July 2010, Tom's taxable income is £28,000 – £6,475 = £21,525. When this gain is added to Tom's taxable income, it will take him well above the threshold of £37,400. Therefore, a substantial proportion of the gain will be taxed at 28%. As a result, it will make sense to deduct the annual CGT exemption of £10,100 from this gain rather than the earlier one which will be taxed at a lower rate.

Notice that the pre-23 June 2010 gain does *not* have to be taken into account when calculating how much of the second gain is liable at 18% (Para 18 Sch 1 F(No2)A 2010).

The chargeable amount of Tom's second gain is £95,000 – £10,100 = £84,900. His unused basic rate band is £37,400 – £21,525 = £15,875. The balance of £69,025 (£84,900 – £15,875) will be taxed at 28%.

Tom's CGT payable for 2010/11 is:

		£
52,000 @ 18%		9,360
15,875 @ 18%	2,858	
69,025 @ 28%	19,327	
		22,185
		£31,545

Entrepreneurs' relief improvements

There are two main improvements to the entrepreneurs' relief regime in F(No2)A 2010. Firstly, the limit has been increased for a second time in 2010/11, on this occasion to £5,000,000 (Para 5 Sch 1 F(No2)A 2010). This latest increase has effect for qualifying business disposals occurring on or after 23 June 2010. Where there have been previous disposals of business assets, the balance of relief still available is calculated in the same manner as described in (c) above. Secondly, the way in which the relief is given has been altered. With effect from 23 June 2010, eligible gains will simply be taxed at a reduced rate of 10% – the concept of a fractional reduction has been abolished.

An entrepreneurs' relief claim on a gain of £5,000,000 or more is now worth £900,000 to a higher or additional rate taxpayer. Where the business is owned by a married couple, the maximum tax benefit is £1,800,000. This is very different from the position just two years ago.

Takeovers

Para 8 Sch 1 F(No2)A 2010 substitutes a new S169R TCGA 1992. This provision applies where shares are exchanged for qualifying corporate bonds (QCBs), typically on a takeover of a company, and a gain on a disposal of the shares for cash could have qualified for entrepreneurs' relief. QCBs are exempt from CGT by virtue of S115 TCGA 1992 and so the main CGT legislation specifies that, on such an occasion, the exchange is not treated as a disposal of the shares. Instead, a gain is calculated as if the exchange were a disposal for cash, but the gain only comes into charge when the QCBs are redeemed. Under the new version of S169R TCGA 1992, an election can now be made for the gain not to be deferred but instead brought into charge at the time of the takeover transaction, accompanied by a claim for relief. If no election is made and the gain is then deferred under the normal rules, the likelihood is that, in almost all cases, the gain will not qualify for relief when it comes into charge at a later date. This revised rule has effect where the exchange of shares for QCBs takes place on or after 23 June 2010 (Para 15 Sch 1 F(No2)A 2010).

CGT deferral relief

Where a gain arises on a business asset disposal and entrepreneurs' relief is claimed, it is possible also to make a claim under Sch 5B TCGA 1992 if the taxpayer invests, within a specified time limit, in EIS shares, in which case the CGT charge is postponed until the occurrence of some future event such as a disposal of the shares. Under the legislation as it stood before the latest changes, it was the gain as reduced by 4/9ths which was set against the EIS investment. Para 9 Sch 1 F(No2)A 2010 modifies the rules for CGT deferral relief in these circumstances following the alteration to the way in which entrepreneurs' relief is given. In future, an individual may choose between claiming entrepreneurs' relief and paying tax on his gain at 10% or deferring the gain under Sch 5B TCGA 1992 and paying tax at 28% (or 18%) when it later comes into charge. Where a gain exceeds the £5,000,000 limit, it will be possible to claim entrepreneurs' relief up to the limit with a 10% tax charge and defer the balance of the gain under the EIS rules. This provision has effect where the business gain arises on or after 23 June 2010 (Para 14 Sch 1 F(No2)A 2010).

Trusts

Entrepreneurs' relief is also available to the trustees of certain life interest settlements. In such cases, the trustees' gain uses up part of the beneficiary's lifetime limit. This rule continues to apply, but, for disposals effected on or after 23 June 2010, the beneficiary's limit is £5,000,000 (£2,000,000 for disposals made between 6 April 2010 and 22 June 2010 (inclusive)).

As mentioned in above, trustees of all types of trust now pay CGT at a flat rate of 28%. In the case of offshore trusts where gains are attributed to UK-resident beneficiaries, the maximum rate has increased to 44.8% – the previous top rate for such distributions was 28.8%.

On the subject of offshore trusts, detailed new provisions are set out in Paras 21 and 22 Sch 1 F(No2)A 2010 where Ss86 and 87 TCGA 1992 are in point. S86 TCGA 1992 applies where the trustees of a settlement are not resident in the UK while the settlor is both UK-resident and UK-domiciled and has an interest in the settled property. The effect of this section is that the trustees' gains for the year (net of any losses) are imputed to the settlor and charged at his rate. For 2010/11, all such gains chargeable on the settlor are treated as if they arose before 23 June 2010, even if they were made by the trustees on or after that date, with the result that they are chargeable at the single rate of 18%. There is therefore the opportunity for such trusts to realise gains at the old 18% rate until 5 April 2011 (Para 21 Sch 1 F(No2)A 2010).

The position with S87 TCGA 1992 is more complex. Gains are attributed to UK-resident beneficiaries if the beneficiary receives a capital payment and the trustees make a gain which would have been chargeable to CGT had the trustees been resident in the UK. Both elements are required before a matching and a consequent attribution occurs for the purposes of these rules. Gains which are matched in the current tax year with a capital payment received before 23 June 2010 are treated as accruing before that date, even if the gains themselves are made by the trustees on or after that date. On the other hand, where capital payments are received on or after 23 June 2010, gains will be deemed to accrue on that date even if they were realised before 23 June 2010 – thus, depending on the beneficiary's tax position, the rate of CGT can be 18% or 28%. In other words, the key date is the date when the capital payment is received (Para 22 Sch 1 F(No2)A 2010).

Other overseas matters

Under S10A TCGA 1992, an individual who makes gains during a period of temporary non-UK residence (where this is less than the five-year period specified) and then returns to the UK is treated as if those gains accrued in the tax year of his return. For a taxpayer in such circumstances who returns to the UK in 2010/11, his gains will be treated as accruing before 23 June 2010 and are therefore taxable at the old 18% rate even if he returns on or after 23 June 2010 (Para 19 Sch 1 F(No2)A 2010).

Para 20 Sch 1 F(No2)A 2010 sets out the position for non-UK domiciliaries who are taxed on the remittance basis. The main aspect of this regime is that gains on the disposal of assets situated outside the UK are chargeable only when they are brought into the UK. Therefore, gains remitted before 23 June 2010 will be charged at the old 18% rate, while gains remitted on or after that date will usually be charged at the new 28% rate. This provision is, however, subject to Para 20(2) Sch 1 F(No2)A 2010 which is explained by the Treasury as follows:

'Para 20(2) Sch 1 F(No2)A 2010 addresses the case where S809J ITA 2007 applies so that a remittance is not treated as a remittance of the actual income or gains being remitted but instead is treated as a remittance of other income or gains in accordance with a special rule. This can occur if an individual who elects for (the) remittance basis has to pay a remittance basis charge of £30,000. Any gains treated under S809J ITA 2007 as remitted during 2010/11 are deemed to arise before 23 June 2010 so that they are chargeable at the single rate of 18%.'

Planning points

As has previously been pointed out, the benefit of entrepreneurs' relief has increased dramatically since the relief was first introduced. Then it was worth up to £80,000 to an individual, but now the maximum value is £900,000. However, this advantage does of course depend on the taxpayer meeting the necessary conditions. The following points should be noted:

In the case of a shareholder, it is necessary for him to hold at least 5% of the company's ordinary share capital (and voting rights) for the 12 months prior to the share disposal, as well as being an officer or employee of the company. Where shares in a private company have been spread around members of the family, it may turn out that some shareholders are not eligible for relief. This position should be checked well in advance of any prospective sale. Another consideration is that a shareholder may currently meet the 5% test, but there are unexercised share options in existence. When those options are exercised, the holding may be diluted below the 5% threshold.

Mention should be made of the associated disposal rules. When the limit was £1,000,000, these provisions might not have been relevant in the context of a company sale. For example, if a husband and wife had sold their company for £4,000,000 in 2009/10, they would almost certainly have utilised their full entrepreneurs' relief entitlements against the share sale proceeds and so the availability of the relief in connection with an associated disposal would have been unimportant. With the increase in the threshold to £5,000,000, this is no longer the case – it will be critical to try and ensure that any 'associated' gain also qualifies.

For disposals made on or after 23 June 2010, the old 4/9ths reduction has been abolished. Instead, the business gain is charged to tax at a flat 10% rate. This revised regime can lead to an increase in the CGT charge in certain circumstances. Imagine a gain of £18,000 which is eligible for entrepreneurs' relief. Prior to 23 June 2010, this gain would have been reduced by 4/9ths to £10,000 so that there would then have been no CGT liability given that the annual CGT exemption was available. However, there will now be an assessable gain of £18,000 – £10,100 = £7,900 for which the tax liability is £790. This point could be important when looking at the level of an EIS investment in order to shelter a gain under the CGT deferral relief provisions of Sch 5B TCGA 1992.

As the economy recovers and more corporate takeover activity starts to materialise, the treatment of any deferred consideration (including earn-outs) will require careful thought. Although it may be possible to claim relief on the initial consideration and so achieve a 10% rate, in many cases when the deferred element matures (typically in the form of the encashment of a loan note), it will be unusual for the vendor to satisfy the entrepreneurs' relief requirements so that he would then be facing a 28% charge. There are ways round this difficulty, but they invariably involve paying more tax up front and so accelerating the CGT charge, albeit at 10%. With earn-outs, attention should

perhaps be given to a cash-based earn-out which has hitherto not been popular because of the impact of *Marren v Ingles (1980)* – in other words, future earn-out payments are made in cash rather than in the form of paper such as shares or, more commonly, loan notes, in which case the provisions of S138A TCGA 1992 may apply. Here, too, the original disposal should usually be eligible for relief, but the subsequent disposals will not.

Finally, one new angle needs to be borne in mind. Where there is a large gain on the sale of company shares on which no entrepreneurs' relief is due, the CGT rate will be 28%. For individuals who are higher rate taxpayers, this is now higher than the effective rate of tax on any distribution received by them. Accordingly, in some situations, it will be preferable to have a dividend rather than a capital gain. This could apply where there is an own share purchase, in which case it may be necessary to break one or more of the CGT treatment conditions. In the event of a normal share sale, pre-sale dividends may again become fashionable – these arrangements have not really been seen for a number of years.

Contributed by Robert Jamieson

Lecture P623 (44.46 Minutes)

Jason Moore and his PPR

The appellant appealed against an assessment to capital gains tax in respect of the sale of a property. Mr Moore claimed that the property had been his only or main residence and was exempt from capital gains tax under TCGA 1992, s 222.

The First-tier Tribunal heard the appellant and his wife (then his girlfriend) acquired the property in December 1999. The property required renovation, but the taxpayer said that intention was that it would become their home.

However, the appellant's wife refused to move in because of unruly neighbours.

The appellant carried out the renovations and ultimately the property was let to tenants. He claimed that he lived in the property for approximately three months, although he admitted that he did not pay any council tax in respect of the property and had no utility or other bills as evidence of occupation.

The tribunal did not accept the appellant's evidence, finding it unreliable on crucial issues. The judge found the purpose of their acquisition was for improvement and then rental gain.

While it was accepted that Mr Moore had occupied the property between December 1999 and February 2000, this had been with the purpose of subsequent letting.

Relief under s 222 was not due.

The taxpayer's appeal was dismissed.

Barn as main residence

The following query appeared in Taxation on 13 October 2010.

Due to a divorce, our client and his wife are in the process of selling their home and we are trying to determine the level of only or main residence relief that they will be entitled to.

In 1997, our client and his wife acquired a barn. In April 2002, they sought planning permission to convert the barn into a residence, and in 2006 work commenced on the conversion.

This work was completed in early 2008, when our client moved into the property. Even in the current economic climate, the property stands at a significant gain.

The problem that appears to exist relates to the apportionment of the gain.

If the gain is apportioned over the entire period of ownership, then only the period from early 2008 to the date of sale would qualify for capital gains tax relief.

However, as the majority of the gain will have accrued since the property was completed, we believe that all of the gain should be treated as covered by only or main residence relief.

We would be grateful for any guidance on this matter.

Query 17,681 – Barnstorme

Reply from Taxplanet

TCGA 1992, s 222 grants only or main residence relief to a gain attributable to the disposal of a dwelling house and to land occupied and enjoyed with the residence as its garden and grounds.

Where the dwelling house and the land have not been occupied as a residence throughout the period of ownership, TCGA 1992, s 223 provides for an apportionment based upon the time the dwelling has been used (or is deemed to have been used) as a residence compared to the total period of ownership.

The question at issue, therefore, is how the provisions of s 223 should be interpreted when a house is built upon land owned before the house was constructed and used as a dwelling.

The matter was considered in Mr & Mrs AJ Henke v HMRC [2006] SSCD 561 (SpC 550) where the facts were similar. In that case, the appellants bought a piece of land in 1982, started to build a dwelling on it in 1991, and took up residence in June 1993.

The Special Commissioner noted that the starting point to interpreting s 223 was to note that, in normal circumstances, buildings cannot be owned separately from land and that the definition of 'land' in the interpretation provisions at TCGA 1992, s 288(1) includes 'houses and buildings'.

From there, he noted that it was the ownership of the single asset consisting of the land and the house built on it that had to be considered as the total period of ownership for the purposes of s 223(2)(b) and that:

> 'It is not specifically provided anywhere in the Act that an individual can be regarded as having a period of ownership of a dwelling house separate from his period of ownership of the land.'

In Barnstormer's client's case, therefore, the total period of ownership of the asset required by TCGA 1992, s 223(2)(b) starts in 1997 when the barn was acquired and ends in 2010, or later, with the date of sale.

The period from which the asset is used as a residence specified in s 223(a) starts on the date in 2008 when the client first used the completed house as a residence and ends with the date contracts are exchanged for sale.

If the period from first occupation to sale is less than 36 months, s 223(2)(a) deems the last 36 months of ownership to be the period of occupation.

Reply from Ji Hao Zhang

When Barnstormer's client acquired the barn in 1997, presumably the couple already had another property to accommodate themselves and the other property was their only or main residence.

Barnstormer is of the view that most of the potential gain has been accrued since the conversion of the barn; therefore, the only or main residence (OMR) relief should be due for the whole or most of the gain.

In order for a residence to be eligible for the OMR relief, it must have been either physically occupied (Capital Gains Manual at CG64465) or deemed to have been occupied as a residence (CG64477) at some time during the ownership period by the owner(s).

The couple did not move into and start using the converted barn as a residence until early 2008, therefore, the physical occupation requirement is not satisfied.

There are certain circumstances, apart from the last 36 months exemption, under which absence from the property is deemed to be a residence for OMR relief purposes (TCGA 1992, s 223(3)):

a) a period of absence not exceeding three years (or periods of absence which together did not exceed three years);
b) any period of absence throughout which the individual worked in an employment or office all the duties of which were performed outside the UK (or lived with a spouse or civil partner who worked in such an employment or office);

c) any period of absence not exceeding four years (or periods of absence which together did not exceed four years) throughout which the individual was prevented from residing in the dwelling-house or part of the dwelling-house in consequence of the situation of his place of work or in consequence of any condition imposed by his employer requiring him to reside elsewhere, being a condition reasonably imposed to secure the effective performance by the employee of his duties;

d) any period of absence not exceeding four years (or periods of absence which together did not exceed four years) throughout which the individual lived with a spouse or civil partner in respect of whom paragraph (c) applied in respect of that period (or periods)

There are further conditions attached that require the dwelling house to be the only or main residence both before and after the period(s) of absence mentioned above, which is obviously not the case here.

Therefore the deemed period of ownership route to the OMR relief is not available either.

The couple may argue that they had always intended to use the converted barn as their only or main residence once the conversion was completed.

However, 'an intention to occupy is not enough' (CG64465) to qualify the property for the OMR relief.

It appears that the couple have not made a nomination, by way of a written notice, in favour of the barn, within the time limit specified by TCGA 1992, s 222(5). I would argue that even if an attempt was made to nominate the barn to be the main residence, it would have been an invalid one.

Merely owning more than one property does not automatically make the owners eligible for the nomination.

Each one of the properties must be used at any time as the owners' residence first, before it can be nominated to be the main residence.

Given the fact that the couple have never used it as their residence before its building work was completed in 2008, the barn would not have been eligible for a nomination.

This then leads us to HMRC's Capital Gains Manual at CG64545, which states that 'where a notice is not made, or an invalid notice is made, the residence which attracts relief is the dwelling house which is the main residence as a matter of fact'.

It then goes on to list a number of factors that are considered in determining the main residence, such as:

- where the family spends its time (although the main residence of an individual should not be 'determined solely by reference to the way in which he divides his time between the two' (see Frost v Feltham [1981] STC 115);
- which address is used for important correspondence, such as bank and credit card statements;
- which address is used to register with a doctor/dentist; and
- where do children go to their school;

It would not be hard to imagine that, given the ongoing building work at the site, the address of the barn would probably not be used for the above purposes until its completion in early 2008.

We then only have extra-statutory concession D49 (ESC D49) left at our disposal. The concession applies to short delay by owner-occupier in taking up residence:

- where an individual acquires land on which he has a house built, which he then uses as his only or main residence; or
- where an individual purchases an existing house and, before using it as his only or main residence, arranges for alterations or redecorations or completes the necessary steps for disposing of his previous residence.

The relief is normally only available for up to one year.

The period may be extended up to a maximum of two years if there are circumstances that are beyond the individual's control and consequently make the period longer than one year.

Unfortunately, the relief is only given when, at the end of the period, the property becomes the individual's only or main residence.

Otherwise, OMR relief only starts from the date the property is used by the owner as the only or main residence (Henke).

Assuming that the sale of the converted barn is completed at the end of 2010, there will be approximately thirteen years of ownership altogether.

There might inevitably be a period between the exchange of contracts and the completion of the sale, during which the residence cannot be occupied.

In practice, this short period of non-occupancy by the owners will normally be ignored by the HMRC.

Although it is only remotely possible, the couple might have another 'purchase for the purpose of realising a gain' hurdle (CG65200 et seq. and TCGA 1992, s 224(3)) to get over.

Assuming that the couple has not made any similar disposals of properties in recent years prior to the disposal of the converted barn, it should not be difficult to demonstrate that they intended to use it as their main residence when they first purchased the property back in 1997.

If this holds true, the OMR relief should not be denied.

To conclude, contrary to what Barnstorm hopes, it appears that the OMR relief available to the divorcing couple would only be approximately three-thirteenths of the potential gain.

Given the size of it, part of the gain may well be subject to capital gains tax at 28%.

Raha v Revenue and Customs Comrs

In 1985 the appellant rented out her property as a furnished letting. On 3 April 2006 the final tenants vacated the property and the appellant decided to sell it. Completion on the property occurred on 1 September 2006 and the appellant made a chargeable gain. In her self-assessment tax return for 2006/2007 the appellant sought to deduct £1,996.80 which she claimed were expenses incurred in preparing the property for sale between the period when the tenants left the property until its eventual sale (and included water rates, council tax, electricity, telephone, service charges, insurance, and furniture clearance). It was common ground that those expenses could not be set off against the earlier rental income. HMRC disallowed the expenses. The appellant appealed contending that (i) the expenses were incurred to prepare the property for sale, to enhance the value of the asset and were reflected in the state or nature of the property at the time of its disposal and so were allowable under TCGA 1992 s 38(1)(b)–which provides: "the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing preserving or defending his title to, or to a right over, the asset". Those words made it clear that the expenditure in question did not have to be capital expenditure. The asset (ie the property) was not just bricks and mortar but "a machine"; (ii) that since there was no income at all there could be no "insufficiency of income or profits or gains" within the meaning of TCGA 1002 s 39(1); and (iii) she sought to deduct her adviser's fee of £950 in respect of his work in dealing with the dispute with HMRC, on the basis that the fee was allowable as "the incidental cost of making the disposal" for the purposes of s 38(1)(c). HMRC submitted that (i) to qualify under s 38(1)(b) the expenditure had to be both capital in nature and to be reflected in the state or nature of the asset. In order for expenditure to be reflected in the state or nature of the asset there had to be a quantifiable improvement to the asset; (ii) the expenses did not constitute incidental costs within the meaning of s 38(2). The disputed expenses were not capital in nature and they were not incurred wholly and exclusively for the purposes of the disposal of the asset; (iii) in any event the expenses were disallowed by virtue of s 39(1) since they were expenses which would have been allowable for income tax purposes but for an insufficiency of income or profits or gains; and (iv) the adviser's fee was not incurred for the purposes of the disposal but rather was incurred in relation to the dispute between the appellant and HMRC as to the correct computation of the chargeable gain arising from the disposal of the property.

The tribunal considered that the words "which … would be so allowable but for an insufficiency of income or profits or gains" were wide enough to cover the case where there was no income. The expenses were disallowed by virtue of TCGA 1992 s 39(1).

The tribunal considered that in order to be allowable under TCGA 1992 s 38(1) the expenditure had to be "reflected in the state or nature of the asset at the time of disposal." That meant it had to lead to an identifiable change in the state or nature of the property. In the instant case there was no identifiable change and the asset itself remained unchanged. It followed that the expenses were not expenditure within the meaning of s 38(1)(b). Furthermore none of the expenses constituted incidental costs of making the disposal as defined by s 38(2).

The tribunal considered that the adviser's fee did not constitute enhancement expenditure within TCGA 1992 s 38(1)(b), nor did it constitute incidental costs of making the disposal within s 38(2). In relation to s 38(2) the fees did not constitute expenditure incurred by the appellant for the purposes of the disposal but rather constituted expenditure incurred in dealing with her tax affairs consequent upon the disposal and in conducting a dispute with HMRC. As such they were not allowable. It followed that the appeal would be dismissed.

Appeal dismissed.

30 September 2010

*Tribunal: Guy Brannan (Judge) and John Clark (Judge), **6 July 2010***

Inheritance Tax and Trusts

The Balfour case (Round 2)

The case of *HMRC v Brander (2010)* has recently been heard by the Upper Tribunal. This is a most interesting and valuable case, given that it analyses the meaning of business property for IHT purposes. Although it is a Scottish case involving Scots law, there are important elements relating to IHT generally which of course applies to the whole of the UK.

The 4th Earl of Balfour had an interest in a farming partnership and was the proprietor of a landed estate in East Lothian, some 30 miles east of Edinburgh. The estate comprised approximately 2,000 acres and consisted of two in-hand farms, three let farms, two sets of business premises and 26 let houses and cottages. There were also some parks which were let on a seasonal basis.

Lord Balfour made no distinction between the partnership and the estate. His own view seemed to be that everything was run as a single business. The First-Tier Tribunal agreed that the whole of the activities represented a single business and that the entirety qualified for business property relief. HMRC appealed to the Upper Tribunal who confirmed the decision in favour of the taxpayer. The First-Tier Tribunal had decided that, as a question of fact, Lord Balfour operated a single composite business and the Upper Tribunal did not feel able to contradict that finding.

Having said that, there are some important implications which arise from this judgment, particularly in connection with the 26 let properties (and possibly with other parts of the estate).

Previously, it would not have been doubted that the passive holding of 26 let properties and the receipt of rent represented an investment activity. The fact that the properties were situated on land on which other commercial activities took place does not make them anything other than pure investment properties. Why then did they not represent excepted assets under S112 IHTA 1984? An excepted asset for IHT purposes is an asset which is neither:

- used wholly or mainly for the purposes of the business concerned; nor
- required, at the time of the transfer (ie. Lord Balfour's death), for future use in the business.

It would be difficult to conclude that the 26 let properties did not satisfy these conditions and could therefore be left out of account in calculating the value eligible for business property relief. However, the First-Tier Tribunal did not even mention the existence of S112 IHTA 1984 and neither did the Upper Tribunal on appeal. Presumably, if one reaches the conclusion that everything undertaken by Lord Balfour (including the ownership of the let properties) represented integral parts of a single business, then S112 IHTA 1984 would have no application because they would be assets used wholly or mainly for the purposes of the business concerned.

However, where does this leave the concept of an excepted asset? If the passive holding of 26 investment properties and the receipt of rent can represent part of an overall business activity, it is a little difficult to see what might be excluded and treated as an excepted asset. A substantial holding of quoted shares could be such an asset, but what real difference in principle exists between the passive holding of an investment property and the passive holding of a portfolio of quoted shares?

There is perhaps a more helpful analysis. It is well established that, when a company carries on a trade and also has some investment assets, one must look at both the trading business and the investment business and determine whether the overall businesses carried on by the company are predominantly trading or whether they are predominantly the making or holding of investments. Provided that the investment business does not predominate, business property relief applies to the whole of the value of the shares, notwithstanding that the investment side may still be extremely significant.

It is possible that this reasoning applies to an unincorporated business in exactly the same way. Can one argue that the whole of the activities undertaken by Lord Balfour consisted of a single business, even though one or more of those businesses were an investment business? If S105(3) IHTA 1984 applies equally to a sole trader so that one may aggregate all that individual's businesses (of whatever nature), then, as long as the investment activities do not predominate, business property relief is allowed in full.

This would not seem to be the reasoning upon which the Upper Tribunal found for Lord Balfour, but it is a reasonable conclusion to be drawn from the judgment. If this analysis is correct, it is a most helpful development in connection with entitlement to business property relief.

Contributed by Robert Jamieson

Lecture P624 (10.00 Minutes)

Another settlements case

The recent case of *Patmore v HMRC (2010)* provides an interesting variation on the position where shareholdings and dividends are arranged so that one spouse can take advantage of his or her basic rate band. In this case, Mr and Mrs Patmore purchased 85 shares in an engineering company in which the husband had been an employee (he already held the other 15 shares). Part of the consideration of £320,000 was paid in cash (financed by a mortgage on the Patmores' matrimonial home) and the balance was to be paid in two equal instalments over the next 21 months. Mr Patmore ended up with 98% of the company (98 'A' shares) and his wife held the remaining two 'A' shares. Some non-voting 'B' shares were then issued to Mrs Patmore and a substantial dividend was paid on these. Mrs Patmore promptly handed her dividend over to her husband and he used it to pay off part of the balance owing to the vendors. HMRC took the view that this constituted a settlement in line with their reasoning in *Jones v Garnett (2007)* and that the dividend should therefore be taxable on Mr Patmore.

This sounds perfectly sensible and indeed the First-Tier Tribunal accepted the point, but only to a limited extent.

The Tribunal's reasoning (which was not argued by either side) was that, when the shares were purchased, the consideration had been provided equally by Mr and Mrs Patmore. However, the wife only received 2% of the 'A' shares (plus her non-voting 'B' shares). The Tribunal therefore decided that there was a constructive trust in Mrs Patmore's favour. She contributed half the capital to buy the shares from the vendors, given that she was jointly liable with her husband on their mortgage and on the loan agreement. She never intended to give her part-share to Mr Patmore. Accordingly, she was entitled to 42.5% of the dividends paid on both the 'A' and the 'B' shares. As a result, the amount of any dividends effectively diverted to Mrs Patmore beyond what she was really entitled to was relatively small.

To summarise:

- the allocation of shares to Mrs Patmore was not a settlement because she was jointly and severally liable for the loans taken out to purchase the 85 shares from the vendors;
- Mrs Patmore was entitled to an equal proportion of those 85 shares from the outset and Mr Patmore held the balance for her under a constructive trust;
- the decision by Mr Patmore in his capacity as the sole director to declare a dividend on one class of share rather than another was an arrangement caught by the legislation; and
- to the extent that Mrs Patmore received dividends which exceeded her 42.5% entitlement, there was a settlement.

This is an interesting variation on the *Arctic Systems* case, although it does not seem to have addressed the point that Mr Patmore did all the work in the company to earn the profits and generate value. The case is likely to go higher.

Contributed by Robert Jamieson

Lecture P625 (11.38 Minutes)

Administration

Prudential v Special Commissioner of Income Tax, Court of Appeal

The Court of Appeal ruled that legal professional privilege (LPP) should not be extended to clients of non-legally qualified accountants or tax advisers.

The issue had arisen in connection with a TMA 1970, s 20 notice served on Prudential in November 2007 in connection with a tax avoidance scheme. The company argued that it was not obliged to disclose any documents in relation to advice on tax matters obtained from counsel, foreign lawyers and PricewaterhouseCoopers.

Lord Justice Lloyd delivered the judgment. Previous decisions resulted in LPP applying only in relation to lawyers. However, counsel for the appellant said that because LPP is a 'judge-made rule', it was open to the court to rule that it could apply to advisers other than lawyers.

The judge pointed to the problem of deciding who is an accountant. He said there are several professional bodies to which accountants may belong – which ones would be covered by the term accountant.

He cited as an example advice given on pensions law. This could be given by a specialist solicitor and barrister, but also by a pension consultant, who may not be legally qualified, but could have the knowledge and experience to give advice.

To make LPP available in those circumstances would 'introduce a substantial degree of uncertainty as to the scope of the rule'.

Lord Justice Lloyd concluded that it was not open to the court to hold that LPP applied beyond the legal profession. It had to be clear and certain in its application. This matter was more suited to Parliament to take up.

The taxpayer company's appeal was dismissed.

The Institute of Chartered Accountants in England & Wales (ICAEW) said it would review the options available on LPP. The ICAEW Tax Faculty's Frank Haskew said, 'The current position is anti-competitive for UK taxpayers and businesses. Whether they consult lawyers or chartered accountants... clients who seek professional advice should be treated in the same way, irrespective of the qualification of the person.'

Describing the Court of Appeal's ruling as 'regrettable', RSM Tenon's Andrew Hubbard said LPP was 'a fundamental concept under which a client should be able to discuss matters with an adviser safe in the knowledge that the advice… remains confidential'. It was the advice that mattered, 'not the status of the person giving it'.

He said further that LPP was 'protection against the state having carte blanche to, in effect, listen in to any conversation between a taxpayer and his or her adviser'.

Mr Hubbard said given that 'the majority of tax advice is given by accountants and other tax professionals rather than lawyers', the matter needed urgent review.

Putting the lawyer's point of view, Ashley Greenbank of Macfarlanes said, 'There is now a material risk that if the accountants lobby for a level playing field between the two professions, the outcome will be restrictions on the scope of privilege afforded to lawyers who give tax advice.

'Any such move could ultimately leave businesses as the big losers if their ability to receive confidential commercially sensitive advice is undermined yet further.'

Lecture B621 (6.27 Minutes)

Reforms to the welfare system

The government has announced that total household benefit payments will be capped on the basis of average take-home pay for working households from 2013 and that child benefit will be withdrawn from households that include a higher rate taxpayer by 2013.

The Chancellor announced today two significant reforms to the welfare system—

- Total household benefit payments will be capped on the basis of average take-home pay for working households (estimated to be around £500 per week in 2013).
- Child Benefit will be withdrawn from households that include a higher rate taxpayer.

Benefits Cap

From 2013, household benefit payments will be capped on the basis of median earnings after tax for working households, which we estimate to be around £500 per week by 2013. All Disability Living Allowance claimants, War Widows, and working families claiming the working tax credit will be exempt from the cap. The cap will apply to the combined income from—

- The main income replacement benefits (Jobseeker's Allowance, Income Support, Employment Support Allowance);
- Other means-tested benefits (including Housing Benefit and Council Tax Benefit);
- Child Benefit and Child Tax Credit;
- Other benefits (including Carer's Allowance and Industrial Injuries Disablement Benefit.

Child Benefit

The Government will withdraw Child Benefit payments from all households containing at least one higher rate taxpayer by 2013. This will save around £1bn a year from the welfare bill. HMRC will implement this policy through the existing PAYE and Self-Assessment structures. The vast majority of families will still receive the child benefit at the current rate.

Business Tax

HMRC Toolkit: Capital v Revenue Expenditure

There is no single, simple test that can be applied to decide which items are capital expenditure and which are revenue. This can only be determined by reference to the relevant facts that applied at the time the expenditure was incurred. In addition the classification of items as capital or revenue expenditure is intrinsically linked to the particular circumstances and the exact nature of the trade.

Record keeping

Good record keeping is essential as poorly kept records can contribute to difficulties in identifying whether a transaction is capital or revenue and treated correctly for tax purposes.

1. Has all capital expenditure on purchase been identified and allocated appropriately?

Risk

Capital expenditure on the purchase of assets may have been charged to the profit and loss account.

Mitigation

Consider whether any items of capital expenditure on the purchase of assets might have been treated as revenue expenditure in the profit and loss account. Developments in the business, such as relocation or expansion, may suggest potential areas in which this may have occurred.

A review of accounts such as repairs and renewals, other expenses, motoring expenses may reveal items of a capital nature, which are not allowable as revenue expenditure but a capital allowances claim may be possible.

2. Has all expenditure on the improvement or alteration of an asset been treated correctly?

Risk

When a business carries out refurbishment of an existing or newly acquired asset, such as a property, some or all of the expenditure may relate to improvement or alteration of the asset. This expenditure will normally be capital for tax purposes, but it may have been included in repairs and renewals or other profit and loss account headings in the accounts.

Mitigation

Where a business carries out work to repair or refurbish either a new or an existing asset, review the expenditure to identify any items that represent improvements or alterations rather than repairs and ensure that they are treated as capital expenditure as appropriate for tax purposes.

3. Has any expenditure on essential repairs to a newly acquired asset been treated correctly?

Risk

If an asset cannot be used as soon as it is acquired because of its poor condition, or the purchase price was substantially reduced to reflect the need for repairs, then the cost of those repairs may be capital expenditure.

Mitigation

Identify any instances where the business has acquired an asset at a reduced cost because essential repairs are required, and the business is prevented from bringing the asset into use until the repair work is done. Consider whether these repair costs should be treated as capital expenditure.

4. Have incidental costs incurred on acquiring or disposing of an asset been treated correctly?

Risk

Incidental expenditure incurred when acquiring or disposing of an asset should be treated as capital expenditure. This will include legal and professional fees incurred in acquiring or disposing of an asset, transportation and installation of the asset.

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Mitigation

Review the profit and loss account for any such incidental costs of a capital nature, and ensure that they are treated appropriately.

5. Has any expenditure on an unsuccessful attempt to obtain an asset or other advantage for the enduring benefit of the business been treated correctly?

Risk

When a business incurs expenditure on an unsuccessful attempt to obtain an asset or other advantage that will be of enduring benefit to the business the expenditure is classified as capital for tax purposes, just as it would have been if the attempt were successful.

Mitigation

Establish whether the business was involved in any unsuccessful attempt to obtain an asset or other advantage for enduring benefit of the business during the period, and if so whether any related legal and professional fees or other costs incurred are capital for tax purposes.

6. Have costs incurred in connection with business' capital structure been treated correctly?

Risk

Legal and professional fees incurred in connection with changes in how the ownership of a business is structured are generally regarded as capital for tax purposes and not allowable as a revenue deduction. Examples might include:

- forming, varying or dissolving a partnership
- the incorporation of a sole trader's or a partnership's business
- a partnership becoming a limited liability partnership
- defending a petition by shareholders to wind up a company

Mitigation

Establish if any legal and professional fees have been incurred on issues relating to the ownership or capital structure of the business, and ensure they have been treated correctly.

7. Have costs incurred on recruitment of additional partners been treated correctly?

Risk

Costs incurred by a partnership on recruiting new partners will normally be allowable as revenue expenditure. However, there are some circumstances in which these costs may be viewed as capital expenditure for tax purposes and so would not be allowable as a revenue deduction.

Mitigation

Where a partnership has incurred expenditure on the recruitment of a new partner or partners, check the circumstances surrounding the recruitment. Examples of where it may be necessary to consider whether the recruitment costs are capital expenditure include:

- Where the admission of the partner has a fundamental impact on the structure of the firm's business. However this must involve more than a mere expansion of the business.
- Where the partner is recruited as part of the acquisition of a business.
- Where the new partner's capital contribution is a material factor in the recruitment.

8. Have costs incurred on training been treated correctly?

Risk

Where costs are incurred on training and development for a proprietor or partner acquiring new skills etc, these may be regarded as capital expenditure for tax purposes and therefore not allowable as a revenue deduction.

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Mitigation

Establish whether training and development undertaken by business proprietors or partners is to update expertise which they already possess, or to give them new expertise, knowledge or skills. In the latter case, if the training brings into existence an advantage of sufficiently enduring benefit the expenditure incurred may be capital.

9. Where any financial payment includes a capital element has it been treated correctly?

Risk

Payments made in respect of finance costs, for example a mortgage, HP agreement or leasing of assets used in the business may include both capital and revenue elements. Following the appropriate accounting treatment for any particular financial obligation will normally ensure that the revenue element is allowed for tax purposes.

Mitigation

Review any expenditure charged to the profit and loss account in respect of finance payments, such as for mortgage, HP or leasing costs. Identify the exact nature of any such finance payments, and the accepted accounting treatment that is appropriate in respect of each of them. Following the appropriate accounting treatment will normally produce the correct allocation of expenditure to capital or revenue for tax purposes.

If any interest has been capitalised as part of the initial asset costs, relief may be available for tax purposes by means of an adjustment in the tax computation.

10. Have all payments made to acquire a franchise been treated correctly?

Risk

An initial payment made by a sole trader or partnership for the acquisition of a franchise is usually capital expenditure, as are any related legal fees. Deductions should not be made on the basis that elements of the initial payment relate to allowable revenue expenditure for specific services, unless they are clearly supported by both the franchise agreement and the facts. See explanation below.

Mitigation

Ensure that all payments relating to an initial fee are treated as capital expenditure, and that any deductions made in the accounts for amortisation are added back. Review legal and professional fees and disallow any costs associated with the acquisition of the franchise.

Consider the franchise agreement and the facts before seeking any alternative deduction on the basis that an element of the initial payment is deductible in respect of actual services provided.

11. Are arrangement fees for any LT security correctly spread over the lifetime of the security?

Risk

Fees paid for the arrangement of long term loans or securities which represent a significant additional cost of finance when compared to the interest payable are allocated to periods over the term of the instrument.

For companies, the accepted accounting treatment of spreading the arrangement fees over the lifetime of the loan should be followed for tax purposes. For sole traders or partnerships relief may be claimed for incidental costs of loan finance under S58 and S59 Income Tax Trading and Other Income Act 2005.

Mitigation

Review long term loans or securities to identify any arrangement or rearrangement fees. Where any such fees are incurred by a company ensure that the accepted accounting treatment of spreading these over the lifetime of the loan or security is followed for tax purposes. For sole traders or partnerships ensure that, if appropriate, relief is claimed for such fees as incidental costs of loan finance.

12. Has the cost of any computer software acquired been treated correctly?

Risk

Where a lump sum payment is made for the acquisition of a software licence, it will be accepted for tax purposes that the expenditure is revenue where the useful economic life of the software is

expected to be less than two years. Where the expected useful economic life of the software is longer the correct tax treatment will depend on the circumstances.

Mitigation

Identify all payments for the acquisition of new software licences, and distinguish between regular periodical payments and lump sum payments. For any lump sum payments establish what the useful economic life of the software is expected to be for the business. For proprietors and partnerships where the expenditure is capitalised and the expected useful life is more than two years, any amortisation is not allowable as a revenue deduction, and a claim should be made for capital allowances. For companies the appropriate tax treatment will depend on the exact nature of the software involved.

13. Has any expenditure incurred on website development been allocated correctly?

Risk

The treatment of expenditure on developing a website is dependent on the function it performs for the business. If the website is capable of directly generating income so that it will become an enduring asset, consideration should be should be given to treating the expenditure as capital.

Mitigation

Review all payments relating to the business website(s), bearing in mind that these may be posted to marketing or advertising rather than IT costs. Where this includes any expenditure on website development consider whether it is capital expenditure.

14. Has the correct tax treatment been followed for amortisation of goodwill acquired?

Risk

The goodwill of a business carried on by a company or a related party at any time before 1 April 2002 does not qualify for inclusion within the corporate intangible assets regime. Relief is therefore not available for amortisation of goodwill acquired before that date.

Mitigation

Where a company's accounts and tax computations include any deductions in respect of goodwill, consider the history of the goodwill and its acquisition by the company. If the goodwill was that of a business carried on by any party before 1 April 2002 then it does not fall within the corporate intangible assets regime until it has been acquired by an unrelated party, and until that time any amortisation of it should be disallowed in computing taxable profits.

15. Has the correct tax treatment been followed for the transfer of an asset within the corporate intangible assets regime either to or from a related party?

Risk

Where there is a transfer of an asset between related parties, and the asset is a chargeable intangible asset in the hands of at least one of those parties, the transfer is generally deemed to have taken place at market value for both parties. If the existence of a related party transaction of this kind is not identified then the wrong amount may be taken into account for tax purposes.

Mitigation

Establish whether any disposals or acquisitions by the company to or from a related party during the accounting period were of assets within the corporate intangible assets regime. For any such transaction, ensure that the amount brought into account for tax purposes reflects the market value of the asset at the date of the transfer.

16. Has depreciation been added back to the accounts profit in the tax computation?

Risk

Depreciation of capital items is generally not an allowable expense for tax purposes, except where the asset is within the corporate intangible assets regime.

There is a risk that the depreciation may not be added back to profit in the tax computation where appropriate. Depreciation of capital items should be added back in the computation even where capital allowances have not been claimed.

Mitigation

Ensure that depreciation of capital items is added back to the profit in the tax computation where appropriate.

Lecture B622 (12.00 Minutes)

Wife joining partnership

On 20 October 2010 an interesting question arose on the Taxation Forum.

A fellow accountant was operating successfully as a sole trader with a number of staff dealing with administration, accounts preparation, audit and tax. He mentioned that part of his plan was to take his wife into practice with him to mitigate his tax liabilities. There does not appear to be any work for her to do and she has no experience or qualifications in accountancy, taxation or, indeed, office management.

My colleague assured me that there would be no problems in this plan, and I started to wonder why I had not thought about this for my own business. However, on reflection I then began to worry about whether there were any adverse tax, National Insurance or, indeed, practice implications to this suggestion.

I am sure that *Taxation* readers must have come across this issue before and I would appreciate any advice that they can give.

Query 17,687 – Big Idea

Replies from Thicket and The Snark

The creation of a husband and wife partnership can produce substantial tax savings. If the husband is earning a substantial amount his marginal tax rate may be 40% or even 50%. If some of this income could be transferred to his wife to absorb her otherwise unused personal allowance and basic rate band, then the total liability will be reduced.

Eligible partner

One practical consideration will be to check the by-laws of any professional body of which the accountant is a member. As an example, the ICAEW does not allow a member practising as a firm who is in partnership with a person who is not a member of one or other approved institutes or societies to describe the firm as 'Chartered Accountants'.

Settlements legislation

Bringing a spouse into partnership when there is no obvious commercial reason, and only a tax-avoidance motive, must put the practitioner on alert for possible attack under the settlements anti-avoidance legislation.

Example 21 in Tax Bulletin 69 concerns a sole practitioner architect earning £80,000 per annum with minimal capital and assets. HMRC state that if his wife is introduced as a partner, this will be a bounteous arrangement transferring income from one spouse to the other and will seek to apply the settlements legislation to tax income on the husband alone.

Contrast this with example 14 (sole trader business where spouse is introduced, but who plays an active part in the business and is exposed to partnership liabilities), where HMRC's conclusion is that this will be acceptable.

My view is that introducing a non-active spouse, contributing no capital, into a business with little or no substance or assets, will be a settlement and may fail all the legs of the exemption for gifts between spouses in ITTOIA 2005, s 626(1) to (3), i.e. an outright gift from one spouse to the other, the right to the whole of the income arising, and which is not itself wholly or substantially a right to income.

The Snark believes that if the legalities are correctly dealt with, including a formal partnership deed in place and probably a capital contribution from the wife, HMRC could not currently challenge such a partnership under the settlements legislation.

<u>Sleeping partner</u>

If the wife does nothing at all, it is possible that HMRC could argue that she is a 'sleeping' partner who takes no active role in the business of the firm but who nevertheless shares or participates in the profits and losses of the firm and has unlimited liability.

The consequences seem to be primarily:

- profit share is treated as unearned income with no Class 4 NIC due
- absence of rollover and entrepreneurs' relief

The inheritance tax position is potentially more interesting because business property relief is dependent on the business not being one of making or holding investments (as opposed to the individual's participation in it).

Taxation Forum

Corporation Tax

HMRC Toolkit: Directors' Loan Accounts

Scope

This toolkit focuses on errors that HMRC find commonly occur.

It should be used for financial years commencing 1 April 2009 for Company Tax returns and will be updated each year to reflect any changes arising from the relevant Finance Act.

1. Have expense headings which could include non-business expenditure paid to or on behalf of directors been reviewed to identify any non-business elements?

Risk

A company may not correctly distinguish non-business transactions such as payments made to or on behalf of the directors (directors' personal expenditure) from business transactions. This may result in non-business expenditure being charged in the profit and loss account instead of to the directors' loan accounts or directors' benefits not being properly returned on form P11D.

Mitigation

A review of the draft profit and loss account may identify account headings where there is an unusual variation or where, based on past experience and knowledge of the business, directors' personal expenditure may be included.

Such account headings may include motor expenses, repairs and renewals, travel and subsistence, sundry expenses and so on. A detailed analysis of these may identify amounts which are paid by the company and which are more properly chargeable to the directors.

Ensure that relevant accounts are analysed and that any directors' personal expenditure is charged to the appropriate director's loan account or included in the payroll records and/or returned on form P11D as appropriate.

2. Have any payments made to or on behalf of the directors that are part of their remuneration package been correctly treated as employment income?

Risk

Payments made to or on behalf of directors or their family or household that are contractual, rewards for work done or are payments for future work are normally considered to be employment income. Employment income includes earnings, amounts treated as earnings, for example benefits and certain other payments. See explanation below.

If such payments are posted to the director's loan account when they are in fact part of the remuneration package this can result in an underpayment of tax and National Insurance contributions (NICs) and an incorrect loan account balance.

Mitigation

Consider the payments made to or on behalf of the director or members of their family or household. Those that constitute employment income, including benefits etc should be subject to tax and NICs and/or returned on form P11D appropriately.

If the payments are not charged as earnings, because they do not have a monetary value or cannot be converted to cash they may be chargeable to tax under the benefits code. In these circumstances the benefit should be included on form P11D. It is important to note that National Insurance contributions (NICs) will be due on most benefits.

Payments that legitimately form part of the director's remuneration package are taxable as employment income and will therefore be an allowable expense of the company.

3. Has any personal expenditure of the directors that does not form part of their remuneration package been charged to the directors' loan accounts as appropriate?

Risk

If the company makes payments to or on behalf of the directors for their personal bills and these payments do not form part of their remuneration package these should normally be charged to the appropriate director's loan account. For example payment of personal bills including credit cards, personal expenses paid by company credit card and personal entertaining, such as of the director's family or friends, can often be overlooked.

If these payments are not charged to the appropriate director's loan account the loan account balance will be incorrect.

Mitigation

Identify any payments the company has made to or on behalf of the directors that do not form part of their remuneration package. Ensure these costs are charged to the appropriate loan account and not the company profit and loss account.

4. Have any relevant credits to the directors' loan accounts been calculated correctly?

Risk

Directors' bonuses, dividends and salaries etc may be credited to the directors' loan accounts. Where such credits are made to the loan account the amount or timing of the credit may be incorrect, for example a director's bonus should only be credited when paid or deemed to be paid. PAYE and NICs should be operated on earnings at the same time and therefore only the net amount should be credited to the loan account.

Where there are credits for other items such as use of the director's home or business expenses paid personally it is important to ensure that the amount reflects the actual or apportioned expense or the loan account balance may be incorrect.

Mitigation

Consider any amounts credited to the directors' loan accounts and ensure that these are for the correct amount and have been posted at the correct time.

Where items such as use of home are included there may be employment income implications.

5. Have all transactions relevant to the directors' loan accounts been posted contemporaneously?

Risk

If transactions are not posted at the time they occur, for example if they are only posted at the year end, an overdrawn balance during the year may be overlooked. Overdrawn loan accounts may constitute a beneficial loan which should be returned on form P11D. If beneficial loans are not returned on form P11D, this can result in an underpayment of tax by the director.

Tax may also be chargeable on the company under S419 Income and Corporation Taxes Act 1988. See Q6+.

For accounting periods ending on or after 1 April 2010 S455 Corporation Tax Act 2010 replaces S419.

Mitigation

Transactions should normally be recorded as they occur and a detailed transaction history maintained, so that it is possible to identify the director's loan account balance on any given date. Where a contemporaneous record has not been kept consider whether the loan account should be reproduced to identify if it has been overdrawn **at any point** during the year. Where a director's loan account is overdrawn **at any point** during the year consider whether there is a beneficial loan and ensure the benefit is returned on form P11D. Also consider whether tax under S419/S455 applies. See Q6+.

Class 1A NICs will also be payable on the P11D benefit and should be reported on form P11D(b).

6. If a directors or participators loan account is overdrawn, has the company paid tax under S419 Income and Corporation Taxes Act 1988 where appropriate?

Risk

Where a close company makes a loan or advance to an individual who is a participator in the company or an associate of a participator (normally the directors and their relatives), the close company is due to pay tax under S419 Income and Corporation Taxes Act 1988. If S419 tax is not paid on the overdrawn amount this can result in an underpayment of tax.

Exceptions from S419 are detailed in S420 Income and Corporation Taxes Act 1988 and exceptions from S455 are detailed in S456 Corporation Tax Act 2010.

For accounting periods ending on or after 1 April 2010 S455 Corporation Tax Act 2010 replaces S419.

Mitigation

Once all appropriate adjustments have been made to the directors' or participators' loan accounts, review the loan account balances at the end of the accounting period. If the loan accounts are overdrawn at the end of the accounting period calculate the S419 tax due and include the amount due with any corporation tax payable. S419 tax is due nine months and one day after the end of the accounting period in which the liability arises. See S419(3) Income and Corporation Taxes Act 1988 and for accounting periods ending on or after 1 April 2010 see S455(3) Corporation Tax Act 2010.

However where the whole or part of a loan or advance is repaid, released or written off, the company is entitled to relief from the tax chargeable under S419 or a proportionate part of it. Where the loan is repaid, released or written off within nine months of the end of the accounting period relief is due immediately. The S419 tax and relevant S419(4) relief should be included and claimed on the relevant Company Tax return. See Q7 below regarding the date relief is otherwise due.

7. If a loan made to a director or participator has been repaid has the S419(4) relief been claimed in the correct year?

Risk

If a loan is repaid more than nine months following the end of the accounting period, relief under S419(4) Income and Corporation Taxes Act 1988 is not due until nine months after the end of the accounting period in which the loan is repaid. If the date of payment is not properly identified relief could be claimed in the wrong accounting period and the Company Tax return may be incorrectly completed.

Mitigation

Identify the date the loan is repaid. If the loan was repaid more than nine months after the end of the accounting period in which the loan was made ensure the relief is not claimed until nine months after the end of the appropriate accounting period.

8. Where an overdrawn loan account has been repaid, has the same or similar amount been withdrawn in the subsequent period?

Risk

If the repayment of the loan account is a temporary arrangement, for example the loan account is repaid by the director or participator at the end of the accounting period (or at the point nine months after the end of the accounting period), and the same or a similar amount is redrawn shortly thereafter, then tax under S419 of Income and Corporation Taxes Act 1988 may still be due.

Mitigation

Establish whether the loan account is overdrawn at the end of the accounting period. Identify whether the loan has been repaid. If the loan has been repaid but a similar sum withdrawn soon after consider whether the book entries reflect the actual underlying transactions. If there is no evidence that the loan has in fact been repaid S419 tax is due. Ensure S419/S455 tax is paid appropriately and S419(4)/S458 relief is not claimed.

Even where the entries do reflect the underlying transactions, depending on the facts, S419/S455 tax can still apply.

9. Have all loans made to directors or participators been considered separately where appropriate?

Risk

Normally each director or participator has a separate loan account, indeed each director or participator may have more than one account. Where there are separate accounts for individual loans/indebtedness each account should be considered separately for S419 purposes even where the loans are to the same director or participator. If accounts are aggregated inappropriately this can result in an underpayment of S419 tax.

The position however is different if the facts show that there is genuinely a joint account. It would though be unusual to find two directors operating a genuine joint account unless they are husband and wife or otherwise closely related individuals.

Mitigation

Ensure each loan and each loan account balance is considered separately and S419/S455 tax calculated on each overdrawn balance.

10. If any loans made to directors or participators have been repaid by way of bonus or dividends, have these been credited correctly?

Risk

Where a loan has been repaid by way of a bonus or dividend it is important to identify the date the bonus or dividend was paid and that the transaction is recorded at the correct date. If the date of the payment of the bonus or dividend is not properly identified this may result in underpayment of tax under S419 of Income and Corporation Taxes Act 1988 or relief being claimed when not due. The date of repayment will affect whether there is a charge under S419 or when any S419(4) relief is due. This may not necessarily be the same date as the date of payment (for other tax purposes) of the bonus or the dividend.

The bonus or dividend should be credited net of any employment taxes.

Mitigation

When a loan has been repaid particularly by way of a bonus or dividend voted at the end of the year, establish the actual date of payment. Ensure that the bonus or dividend is not credited to the loan account before the date of payment, which may differ from the date that the bonus or dividend is voted or provided for in the accounts which is often the accounting date. If the loan account remains overdrawn at the accounting date S419/S455 is due. The date of payment will also affect the date S419(4)/S458 relief may be due.

11. Have released/written off loans made to directors or participators been treated correctly?

Risk

Where a loan or indebtedness has been released or written off, then relief under S419(4) of Income and Corporation Taxes Act 1988 will be due to the company as in Q7. However there may also be a charge under S415 ITTOIA 2005 on the director or participator. If so, they will be treated as being in receipt of income which has been taxed at the dividend ordinary rate. In addition, National Insurance contributions (NICs) will normally be due on the amount released or written off.

Mitigation

Consider whether any loans etc have been released or written off and whether S415 ITTOIA 2005 will impose a charge on the director or participator as dividend income. Where loans have been released or written off company claims to relief under S419(4)/ S458 can be made accordingly.

For Income Tax purposes the amount released or written off should normally be included on the director's Self Assessment return. For NICs purposes the amount released or written off should normally be treated as earnings liable for Class 1 NICs.

Where the director is not a participator the treatment can be complex, a charge to tax will arise either under S62 Income Tax (Earnings and Pensions) Act 2003 as earnings or as a benefit under S188 Income Tax (Earnings and Pensions) Act 2003.

Lecture B623 (21.35 Minutes)

Bamburg v Revenue and Customs Comrs

On 14 February 1997 W, then a wholly-owned subsidiary of C, borrowed £15 million by way of unsecured loan notes repayable on 31 December 2010. On the same date W guaranteed the liability of C in respect of £30 million of loan notes issued by C and purchased by the bank. Under that arrangement W was required to deposit £15 million with the bank. W subsequently suffered a forfeiture of that sum. On 4 May 2000 the appellant purchased the issued share capital of W and purchased all its loan notes for £237,000. On the same day the appellant sold the issued share capital of W to T for £2. At all material times the appellant owned 100% of the shares in T and was a director of W and T. Between 2000 and 2002 T made loans to W which were used to repay part of W's loan stock to the appellant. On 1 February 2002 T transferred its trade and all its trading assets to W and the hive down was at book value, no value being attributed to goodwill. Until the hive-down every time there was a repayment of loan stock by W, T lent a corresponding amount to W immediately before. Following the hive down T ceased to trade. W continued to trade and further repayments of its loan stock were made to the appellant. HMRC issued assessments under TA 1988 s 703 on the basis that the appellant had obtained a tax advantage; that Circumstance D, as outlined in TA 1988 s 704, applied because the distributable reserves of T were represented by the value of assets available for distribution by way of dividend; that the loans by T to W and the subsequent hive-down were transfers of those assets; and in connection with such transfers the appellant received those assets in a form that he did not bear tax on them as income, namely repayment of W's loan stock. The appellant appealed contending (i) the exclusion in Circumstance C(2) applied to the redemption of the loan stock as it represented a return of sums paid by subscribers on the issue of securities. If C(2) was limited to companies governed by foreign law which could pay dividends out of share capital there was otherwise no let out (except from the escape clause in s 703(1)) for the repayment of loans in circumstances in which a dividend could have been paid; (ii) the loans made by T to W before the hive-down were genuine loans and were not the distribution of profits because T's distributable reserves were not diminished; and (iii) after the hive-down the profits made by W were its own profits and those were not available for distribution because of the large negative reserves of that company. HMRC submitted that the exclusion in C(2) was restricted to companies governed by foreign law so that even though foreign law enabled distribution of share capital by way of dividend, a company was not disadvantaged compared to a UK company. The words in brackets specifically referred to foreign law; and (ii) there was no need for there to be an outright distribution of profits at each stage of the series of transactions, given the definitions that distributions of profits included transfer of assets. The loans were transactions between companies owned by the appellant.

The tribunal considered that Circumstance C(2) in TA 1988 s 704 could apply to a UK incorporated unlimited company. The courts had assumed that the words in brackets referred solely to foreign law so that even if foreign law permitted dividends out of share capital that was to be ignored with the effect that foreign companies were treated no worse than UK incorporated companies. However, in none of the cases did the possible application of C(2) to a UK company affect the decision since in all of them it was accepted that the capital of the particular UK companies was not available for distribution by way of dividend, and therefore whilst there were clear statements that C(2) was restricted to foreign incorporated companies, those were obiter comments. There was no reason why C(2) should not be applicable to a UK company.

The tribunal considered that the fact that C(2) could be applicable to a UK company did not, however, prevent the repayment of the amount originally subscribed for W's loan stock from being within Circumstance D in the present case. The effect of C(2) was that assets representing a return of sums paid by subscribers on the issue of securities were not available for distribution by way of dividend; it was not that the return of assets subscribed was never caught by Circumstance D. The fact that the loan stock was W's and the assets in question went into W as loans before the hive-down, and as the transfer of assets in consideration of a debt on the hive-down, did not prevent those assets from continuing to represent assets available for distribution by T by way of dividend. The appellant had received in the form of repayment of W's loan stock tax-free consideration that represented assets that were available to T for payment of dividend having been lent by T to W (or transferred to W in exchange for a debt in the hive-down). Before the hive-down loans were made that exactly corresponded to the repayments of W's loan stock to the appellant. After the hive-down the assets were already in W and available for repaying the loan stock. The assets had merely been replaced by a debt due to T of the same amount that was still an available asset, as seen from the fact

that the same amount of distributable reserves were still in T after the hive-down. Those facts were sufficient to bring Circumstance D into effect.

The tribunal considered that the effect of the words in brackets in C(1)(i)—'assets which are (or apart from anything done by the company in question would have been) available [assets]'—was that they applied if one started with actually available assets, to which the company had done something to prevent them from being available, the obvious example being capitalising them. On the hive-down there was a transfer of assets that represented the value of available assets of T corresponding to its distributable reserves up to the date of the hive-down, which remained available assets. Following the hive-down, if W was taken to be the company referred to in the passage in brackets, the assets representing those profits were not available assets because of the negative distributable reserves in W. W could not logically have done anything to them apart from which they would have been available assets. It might have paid them away in repayment of loan stock but that had not made them any the less available. If T was the company referred to in the passage in brackets, for the appellant to succeed he would have to show that the assets representing W's profits after the hive-down also represented T's assets which apart from the hive-down (and presumably the repayment of the loan stock by W) would have been available assets of T. For that to be satisfied T would have to be able to look into the future to know that it would have made the same profits as W did. The hypothesis extended to a company's action in making its available assets into non-available assets; it did not extend to making one company's non-available assets into a different company's available assets by saying that the assets would have accrued to the latter company but for the hive-down. The fact was that the profits after the hive-down did not accrue to T and they never were available assets to T to which that company had done something to make into non-available assets. Whichever basis one read the words in brackets, the condition was not satisfied. Accordingly, the assets representing profits made by W after the hive-down were not assets that would have been available to T for distribution by way of dividend on the basis that apart from the hive-down those profits would have been made by T. It followed that the appeal would be dismissed up to the amount of distributable reserves of T until the hive-down but allowed in respect of any further profits made by W after the hive-down.

Appeal allowed in part.

14 October 2010

Draft regulations in response to IFRS9

HMRC have published a discussion paper relating to draft regulations on the amendments to parts 5 and 7 of CTA 2009, to be made under s 465A and s 701A.

The proposals relate to changes in accounting standards on financial instruments arising from the introduction of International Financial Reporting Standard 9.

The proposed regulations consider the impact of changes in the classification and measurement of financial instruments, and make changes in the following areas:

- the definition and application of a change of accounting policy;
- the adjustments to be made on a change of accounting policy;
- the rules on hybrid and compound instruments;
- transitional adjustments under the Change of Accounting Practice Regulations;
- other consequential changes.

Further draft regulations will be issued when the International Accounting Standards Board's proposals for new standards on impairment, hedge accounting, derecognition and other changes to IAS 39 have become clearer.

Comments on the draft regulations are invited and should be sent by 15 October 2010 to Tony Sadler, Fiona Hay or Adeline Chan.

Foreign profits taxation and 'worldwide debt cap'

On 14 October 2010, the government tabled two amendments to Schedule 5, which correct defects in the drafting to enable regulations to be made in certain circumstances to deal with mismatches arising between the accounts of the worldwide group and figures used by the UK company in calculating the amount of the debt cap restriction.

SCHEDULE 5(25) - AMENDMENT 8

Schedule 5(25), in new TIOPA 2010, s331A(1) leave out from "accounts amount" to end of s331A(2)(c) and insert 'in respect of a matter is not equal to the tax amount in respect of that matter.

(2) For this purpose—

(a) the "accounts amount" in respect of a matter is—

(i) the amount disclosed in the financial statements of the worldwide group in respect of the matter, or

(ii) if no amount is so disclosed, nil, and

(b) the "tax amount" in respect of a matter is—

(i) the amount of the deduction to which a member of the worldwide group is entitled under a provision of the Corporation Tax Acts in respect of the matter,

(ii) if more than one member is entitled to such a deduction, the total such deductions, or

(iii) if no member is entitled to such a deduction, nil.'.

SCHEDULE 5(28) - AMENDMENT 9

Schedule 5(28), in new TIOPA 2010, s336A(1), leave out from 'accounts amount' to end of s336A(2)(c) and insert 'in respect of a matter is not equal to the tax amount in respect of that matter.

(2) For this purpose—

(a) the "accounts amount" in respect of a matter is—

(i) the amount disclosed in the financial statements of the worldwide group in respect of the matter, or

(ii) if no amount is so disclosed, nil, and

(b) the "tax amount" in respect of a matter is—

(i) the amount of the deduction to which a member of the worldwide group is entitled under a provision of the Corporation Tax Acts in respect of the matter,

(ii) if more than one member is entitled to such a deduction, the total such deductions, or

(iii) if no member is entitled to such a deduction, nil.'.

Explanatory note

Amendments 8-9: schedule 5: financing costs and income of group companies

Summary

1. Clause 11 and Schedule 5 make a number of changes to the corporation tax rules on the "worldwide debt cap" legislation, which restrict the finance costs that can, for tax purposes, be deducted by a UK company to the total finance costs claimed by the worldwide group of which it is part. Two of the changes are to enable regulations to be laid to deal with mismatches between the figures that are drawn from the accounts of the worldwide group and those used by the UK company in calculating the amount of the debt cap restriction. However, the powers as drafted do not apply to mismatches that arise where no amount appears in the consolidated worldwide group accounts or if the amount used by the UK company is nil. Amendments 8 and 9 resolve this issue.

Details of the clause

2. Paragraph 25 inserts new section 331A into Chapter 8 of Part 7 of the Taxation (International and Other Provisions) Act 2010 (TIOPA). This chapter deals with computation of the tested expense amount and the tested income amount. New section 331A provides a new regulation-making power.

Regulations made under this power may apply to any situation where, in respect of the same debt, there is a mismatch between the "accounts amount" that contributes to the computation of the available amount of the worldwide group, and the "tax amount" taken into account in computing the net financing deduction of a UK Company. The regulations can change the way in which the tested expense amount or the tested income amount is calculated in order to correct such mismatches, and can amend any provision of Part 7 in order to do this.

3. New section 331A(2) currently defines "accounts amount" as the amount of any expenses disclosed in the financial statement of the worldwide group. Amendment 8 extends this definition to include the case where no amount is disclosed in the financial statement of the worldwide group in respect of the matter; in that case the amount is nil. The amendment also deals with the case where an amount is disclosed in the financial statements of the worldwide group but no deduction under the Corporation Tax Acts in respect of the same matter is included in the tax amount of a member of the worldwide group.

4. Paragraph 28 inserts new section 336A into Chapter 9 of Part 7 of TIOPA. The new section confers a regulation-making power similar to that in new section 331A. As with new section 331A, the regulations are intended to correct mismatches between the accounts amount and the tax amount. Regulations made under this section will correct the mismatch by changing the way in which the available amount is calculated and can amend any provision of Part 7.

5. Amendment 9, to new section 336A(2), is the same as that for new section 331A(2). The definition of "accounts amount" is extended to include the case where no amount is disclosed in the financial statements of the worldwide group in respect of the matter, in that case the accounts amount is nil. The amendment also deals with the case where an amount is disclosed in the financial statements of the worldwide group but no deduction under the Corporation Tax Acts in respect of the same matter is included in the tax amount of a member of the worldwide group.

Background note

6. In Finance Act 2009 a package of changes to the taxation of companies on their foreign profits was introduced. The package included the introduction of a measure to restrict the interest and other finance expenses that can be deducted in computing the corporation tax payable by the UK members of a worldwide group of companies.

7. The debt cap rules introduced as Schedule 15 to FA 2009 have now been rewritten as Part 7 of TIOPA. They broadly operate by requiring UK groups to compare their UK financing costs, as calculated under the Schedule, with the finance costs of their worldwide group as disclosed in the consolidated financial statements of the group. If the UK costs exceed the worldwide costs then the UK companies do not get any relief for the excess.

8. Further discussions with industry identified that some amendments to the debt cap rules would be needed to address issues that emerged subsequent to the passage of Finance Bill 2009. A number of changes were announced on the 9 November 2009. Draft legislation incorporating these points was published with the 2009 Pre-Budget Report.

9. The current Schedule incorporates these changes, along with a small number of further changes that arose from the subsequent consultation on the draft legislation. The changes include two new powers to lay regulations which as drafted would not enable the correction of a mismatch if in relation to a matter no expenses were disclosed in the financial statements of the worldwide group or no company within the group was entitled to a deduction under the Corporation Tax Acts. The amendments should enable regulations to be made that deal with such mismatches.

Sponsorship payments

The First-Tier Tribunal has recently heard the case of *Interfish Ltd v HMRC (2010)* which concerned the deductibility of sponsorship payments made by a trading company to Plymouth Albion Rugby Football Club. The question was whether such payments were allowable in computing the company's profits for corporation tax purposes.

Interfish Ltd was a substantial company in the fish industry based in Plymouth. The controlling director, Mr Colam, was interested in rugby and he took the view that, by sponsoring the local rugby club, he would obtain influence for his company within the business community for which the club acted as a focal point. A lot of evidence was given about the advantages which flowed from that

sponsorship and Mr Colam was emphatic that the payments were made with a view to achieving those benefits. The Tribunal found as a fact that the payments would not have been made if the anticipated benefits had been unlikely to accrue to the company. Mr Colam was clearly not using his company to help finance the club simply in order to give himself the satisfaction of being seen to be a benefactor.

For tax purposes, the test was the traditional one, now found in S54 CTA 2009, that, in calculating the profits of a trade, no deduction is allowed for expenses not incurred wholly and exclusively for the purposes of that trade.

The Tribunal examined the celebrated case of *Mallalieu v Drummond (1983)* where it was decided that expenditure on professional clothing also had a private (albeit subconscious) purpose. The case of *Bowden v Russell & Russell (1965)* was considered as well where the taxpayer (a solicitor) incurred travel expenditure both to promote his profession and to take a holiday. Each of the cases failed on the ground of duality of purpose. The judge found that Interfish Ltd's sponsorship payments were not deductible for the same reason.

However, did the judge apply the correct test? Both the cases referred to in (d) above related to unincorporated businesses where it was held that personal benefit played some part in the motivation for the payments. However, a company (in this case, Interfish Ltd) can have no personal benefit. The only persons capable of having a personal benefit in this context are the directors and employees. If, therefore, the reason for the sponsorship payments was partly to benefit the company's business and partly to advance some purpose of the directors or employees, it should still be fully allowable. The provision of benefits to directors or employees is clearly expenditure laid out wholly and exclusively for the company's trade. It could perhaps be said to give rise to a benefit in kind charge, but that is hardly relevant here.

It may be that, as happened in *Executive Network (Consultants) Ltd v O'Connor (1996)*, the identity of the recipient of the sponsorship and the director's keen interest in the club has confused the analysis of the tax treatment. In any event, it is assumed that the company will appeal.

Contributed by Robert Jamieson

Lecture B624 (9.17 Minutes)

Value Added Tax

VAT Assessments

Background

This article reviews the rules which HMRC must follow when raising a VAT assessment. These are illustrated by two recent cases which are summarised below and a recent Reader's Query in Taxation magazine, which raised an important practical issue.

Summary of the rules

The principal rules for assessments are in s.73 VATA 1994. This provides that:

- an assessment must be raised to the best of the officer's judgement;
- it must be notified to the taxpayer;
- it must relate to a return period;
- it must be raised within the prescribed time limits.

Best judgement

The issue of best judgement has been considered in many cases. It is clear that an officer does not have to carry out such a detailed investigation that the assessment is correct, i.e. the same figure that the taxpayer would have produced if the taxpayer had accounted for VAT properly at the time. Only the trader can do that. To be "to best judgement", an assessment must:

- be based on some evidence that is relevant;
- be logically sound, i.e. any calculations must be correct and any extrapolation must be sensible;
- not ignore relevant evidence that was available when it was raised;
- be an honest attempt to produce a fair and reasonable answer, and not be raised capriciously or maliciously.

It is very rare for an assessment to be overturned because it has been maliciously or capriciously raised. Sometimes the Tribunal accepts a trader's argument that an assessment is based on flawed logic and therefore has to be rejected completely. If the underlying logic is sound but there are errors of detail (such as calculations, or particular assumptions that are considered to be wrong) then the assessment can be valid in principle but adjusted in amount.

The use of extrapolation is something that traders may find particularly harsh. If an investigation suggests that receipts have been omitted from the accounting records, an extrapolation for several years can be based on a very small sample of observations. The Tribunal is likely to accept the validity of such an exercise; the trader will have to argue that the occasions chosen for observation are not representative, and may achieve a reduction in the assessment on that basis, but is unlikely to be able to undermine the assessment as a whole.

Notification and period

Very occasionally an assessment fails because it has not been notified to the taxpayer. Strictly, an assessment is "raised" for the purposes of the time limits on the date that it is recorded in HMRC's internal records, not on the date when the taxpayer receives it. As a matter of policy, HMRC apply this rule as requiring them to send the assessment to the trader's last known address by the last date on which the assessment must be raised.

An assessment must relate to a return period. If an assessment is raised for a period which does not correspond to the trader's return periods, it is invalid.

Two situations can cause particular uncertainty:

1. when a trader has not registered for VAT at the right time, HMRC are likely to issue a notice of compulsory registration with a backdated effective date of registration. They will specify a "registration period" which runs from that past EDR to a current date, and the registration period can be any length (in theory, from April 1973 onwards). An assessment can be raised for the whole of the registration period as a single sum.
2. a single document may set out assessments for several different return periods. As long as the different amounts for different periods are broken down and separately identified, the assessment is valid. If it only gives a total which is supposed to apply to a length of time which is longer than a single return period, it is not valid.

Time limits

It is important to appreciate that the time limits for HMRC to obtain evidence on which an assessment may be based are not the same as for direct tax self-assessment. There is no equivalent of the "enquiry window" after which HMRC are not allowed to start asking questions about a return. They can obtain information using the powers in Sch.11 VATA 1994 at any time; however, they must use that information to raise an assessment in accordance with the time limits in s.73 and s.77 VATA 1994.

An assessment can be raised:

- in any case, within two years of the end of the return period to which it relates;
- if later than the above, within one year of HMRC having sufficient information on which to base the assessment; but
- subject to the overall limit of four years from the end of the return period; unless
- there is a loss of tax due to fraud or dishonesty, in which case the overriding time limit becomes twenty years from the end of the return period.

The overriding limit of four years was three years up to 31 March 2009. During a transitional year to 31 March 2010, the time limit was increased to four years by permitting assessments for any period ending on or after 1 April 2006. From 1 April 2010, the four year time limit applies.

What this means is that:

If HMRC discover sufficient information to:

- raise an assessment within the first 12 months after the end of a return period, they can always apply the 2 year limit – they have potentially more than 12 months to use the information;
- raise an assessment between 12 months and 36 months after the end of a return period, they must apply the one year limit – they have no more than 12 months to use the information;
- raise an assessment more than 36 months after the end of a return period, they will be up against the 4 year limit – they have less than 12 months to use the information.

Arguments in this area often arise when HMRC raise an assessment between two and four years after the end of the return period. They will have to be able to show that they discovered something that was crucial to the assessment within the 12 months before they raised it. This is sometimes referred to as "restarting the clock". If they had all the information which they have used to raise the assessment more than 12 months before it was raised, the assessment will be out of time.

Best judgement

A Tribunal decision provides a useful and relatively brief explanation of the principles of an argument about whether an assessment has been raised "to the best of the officer's judgement". A retailer of computers was visited and the officer concluded that the records were unreliable. After removing the records for more detailed examination, he revised the company's date of registration and issued assessments. These were based on extrapolation and assumptions, and the taxpayer protested that they were wrong (after considerable delay). When the matter came before the Tribunal, the chairman considered how the figures had been arrived at by the officer and concluded as follows:

Having regard to those principles we find that Mr Evans' calculations were based on relevant material and he put his calculations to the Appellant for its comments. For whatever reason these were only forthcoming after some considerable delay but Mr Evans nevertheless considered them and in due course responded to them by reducing the assessment to take account of the Appellant's further submission. To the extent that the Appellant continued to criticize the basis of Mr Evans' calculations and his reliance on the October sales listing we consider that those criticisms are without foundation having regard to the information that was available to him. Mr Evans made a value judgment on the information which he had and performed his function honestly and bona fide. He fairly considered all the information and came to a decision which was reasonable and not arbitrary as to the amount of tax due. He made an honest and genuine attempt to reach a fair assessment. Having regard to the downward adjustment that Mr Evans made to his original assessment we do not believe that the final assessment of £7,337.61 can in any way be described as excessive.

The key starting point to such an assessment is that there must be a reasonable ground to believe that the returns are not complete or accurate, and this was the case here. Once the trader's self-assessment has been undermined, the officer does not have to reproduce exactly the figures that the trader ought to have calculated – extrapolation based on estimates is acceptable, provided that all available information has been fairly and logically considered.

First Tier Tribunal (TC00639): Nabiltech UK Ltd

Time limits

HMRC raised four assessments totalling £7m on Weight Watchers (UK) Ltd, arising from the dispute about compound and multiple supplies that went to the Court of Appeal. All the assessments were raised more than two years but less than three years after the periods to which they related. The company argued that they were out of time because they were not raised within one year of the time at which knowledge of the facts, sufficient to raise the assessments, was in the possession of the Commissioners.

The dispute between HMRC and the company began in March 2005 with a voluntary disclosure by the company, claiming back some £7.25m in respect of output tax accounted for during the preceding three years. The company then made returns for succeeding periods on the basis that there were separate supplies of standard rated services and zero-rated printed matter.

The company was successful in its appeal to the Tribunal, and in March 2007 HMRC repaid the VAT claimed in the voluntary disclosure to the company. The repayment was accompanied by a warning that HMRC were considering an appeal and, if such an appeal was successful, they would require further information about sales for later periods.

The Court of Appeal's decision in favour of HMRC's position was given in June 2008. Shortly afterwards, a new HMRC officer e-mailed the company asking for details of sales in the period to September 2005, noting that it would shortly pass the time limit for raising an assessment. It was also noted at that time that an assessment would not be raised for June 2005.

The exact figures were not provided in time, so HMRC raised an estimated assessment on 29 September 2008 for the September 2005 period. This was based on figures provided by the appellant in March 2005. After a request for reconsideration, HMRC accepted that this assessment had been raised out of time, but asked for accurate figures to be provided for the December 2005 quarter no later than 15 December 2008 so that an in-time assessment could be raised.

The argument was raised in correspondence at this time that was the basis of the appeal before the Tribunal: if HMRC received new information at this time, presumably it would start the clock running for an assessment within the next 12 months (subject to the three-year cap). If they did not receive new information, any assessment that they raised "to best judgement" would have to be based on information that they had held for more than 12 months, and it would therefore be out of time.

It appears that the company might have had an incentive not to provide more detailed information, but it agreed to do so by 29 December 2008 in respect of the December 2005 quarter, and by 28 February 2009 in respect of the 2006 return periods.

HMRC argued that the officer raising the assessments believed that she had to have accurate figures rather than estimated assessments based on extrapolation from earlier periods. She therefore did not have sufficient information to raise the assessments without asking for further details. The company

argued that HMRC had enough information to raise a best judgement assessment, and therefore the failure to do so within 12 months of having it meant that any subsequent assessment was out of time.

The Tribunal comments that it is "odd" that HMRC knew in March 2007 (well within the 2-year time limit for all the periods concerned) that they would need more accurate information if they wanted to raise accurate assessments in accordance with what they believed was the correct legal principle. However, they did not ask for that information until after the Court of Appeal decision.

However, the Tribunal did not consider that anything turned on this. The appellant's construction of the law was "strained, if not impossible": it required the time limit to be applied to a possible assessment, rather than the assessment that was actually raised. It was certain that the assessments actually raised could not have been prepared without the information that was provided within the 12 months before their issue. The HMRC officer conceded in her evidence that if the company had not complied with the request for information in December 2008, HMRC would have "lost the money" in respect of the December 2005 period. That is an uncomfortable conclusion, because it suggests that delay by the taxpayer would have saved it a great deal of money, whereas co-operation has been very costly.

First Tier Tribunal (TC00666): Weight Watchers (UK) Ltd

Forgotten assessment

A Reader's Query in Taxation (11 August 2010) raised the question of whether the trader is under any obligation to warn HMRC that the time limit for raising an assessment is about to expire. Here is one of the responses:

HMRC must raise VAT assessments within the prescribed time limits in s.73 and s.77 VATA 1994. They always have two years from the end of the return period concerned (s.73(6)(a)); if there is no dishonesty they have a maximum limit of four years from the end of the return period (s.77(1)), but if the two year limit has passed, they also have a limit of "one year after evidence of facts, sufficient in the opinion of the Commissioners to justify the making of the assessment, comes to their knowledge" (s.73(6)(b)).

Let us suppose that the control visit happened in August 2009. Suppose also that the discrepancies related to VAT periods December 2007 and December 2008. In respect of December 2008, HMRC could raise an assessment up to the end of December 2010, even if that is more than 12 months after August 2009. They always have those two years.

In respect of December 2007, they have an absolute limit of 31 December 2011. If they acquired enough knowledge to raise the assessment at the control visit, they must raise the assessment by the anniversary of that visit, August 2010. If they were to raise assessments for both these periods in December 2010, the December 2007 period would be out of time.

When there is a question of an assessment being out of time, the issue is when HMRC had sufficient information to raise it. If they raise the assessment "out of the blue" over a year after they last asked the taxpayer a question, it is hard for them to sustain an argument that anything happened in the last year to add to their knowledge. Once they have stopped collecting information, they have to use it within a year.

They may look back at the preceding 12 months and try to identify something which they say they discovered in that period and without which they could not raise the assessment. They may have corresponded with the client or the adviser, or carried on other investigations which were outside the knowledge of the client. They would have to show that there was something which "started the 12 month clock". A leading case on this issue (where the taxpayer lost) is Pegasus Birds Ltd v C & E Commrs (No 1), CA [2000] STC 91; for a recent case, where the First Tier Tribunal had two goes and decided both times that HMRC had missed the boat, see Sophie Holdings Ltd (TC00056 and TC00144).

It is unsatisfactory for all parties that the client has to wait on tenterhooks to see if HMRC will assess. If the VAT is due, the taxpaying public should be able to rely on HMRC to collect it efficiently, and the taxpayer should be put out of his misery. On the other hand, it is difficult to see that it is the client's or the accountant's duty to do more than answer questions that HMRC raise truthfully and promptly. If that has been done, then I believe that the ball is in HMRC's court. If they fail to return it within the time limit, then that is their business. I suspect that a client would

have at the very least grounds for complaint, and possibly even a legal claim, if the accountant took it upon himself to remind HMRC that the time limit was about to run out!

Taxation 11 August 2010

Contributed by Mike Thexton

Lecture B625 (17.41 Minutes)

CRC v Loyalty Management UK Ltd and another company

The European Court of Justice (ECJ) recently gave its judgment in respect of the joined cases of Loyalty Management UK Ltd and Baxi Group Ltd.

The first company, Loyalty Management, which runs the Nectar customer loyalty rewards programme, entered into various agreements with retailers, customers and suppliers (also known as redeemers).

Under the retailers agreement, the retailer issued points to customers and paid to the taxpayer a specified sum in respect of each point issued, and a marketing fee. Customers could purchase good from suppliers using their loyalty rewards.

Loyalty Management then paid the suppliers an agreed fee. The company claimed the input VAT on the fee paid to the suppliers. HMRC refused the claim.

The second company, Baxi, a boiler and heating products provider, faced a similar problem in respect of input VAT. It operated a loyalty scheme for its customers, i.e. installers of boilers.

However, unlike Loyalty Management, Baxi sub-contracted the operation of its rewards scheme to @1 Ltd.

@1 Ltd chose and purchased the loyalty rewards and supplied them to customers which meant that it acted both as the operator of the rewards scheme as well as the redeemer. Baxi claimed the VAT on the sums paid to @1 Ltd.

The appeals process in respect of both companies progressed through the courts, until the House of Lords referred the matter to the ECJ.

The ECJ ruled that payments made by the operator of a reward scheme to the suppliers who supplied rewards to customers had to be regarded as consideration, paid by a third party, for a supply of goods or services to those customers. The taxpayer companies were therefore not entitled to deduct input tax paid on the charge.

Giles Salmond, a director in the tax dispute resolution group at Deloitte, said the ECJ's decision would 'impact upon many businesses in the UK which operate loyalty schemes'.

He added: 'It is likely that the case will go back to the Supreme Court before the VAT position is clear. The case may also be significant in determining whether businesses can recover VAT when they make payments for services rendered both to that business and to third parties, for example, as sometimes happens with the payment of professional services provided in the context of M&A activity.'

Lorraine Parkin, VAT partner at Grant Thornton UK LLP, said the judgment was 'bad news for businesses operating a customer loyalty scheme as the amount of VAT that can be claimed will now be restricted'.

She continued: 'Both of the decided cases involve complex multi-party transactions and a duty of care to more than one entity, an arrangement that is quite common for businesses in the UK.

'It is therefore very disappointing that the ECJ has failed to comment on the EU principle of fiscal neutrality and has interpreted the VAT system in a way that is inconsistent with commercial practice.'

(C-53/09 and C-55/09), European Court of Justice

ECJ case overturns High Court ruling in JDL v CCE

HMRC have published details of their review of the treatment of claims submitted as a result of the *Italian Republic* (C-45/95) decision.

The claims are for output tax over-declared on car sales where input tax was blocked on the purchase of the cars often involving the sale of demonstrator vehicles, courtesy cars and daily rental vehicles by businesses in the motor trade.

In *Nordania Finans A/S v Skatteministeriet* (C-98/07), a case which concerned whether cars bought for leasing followed by sale were capital goods used in the business, the European Court of Justice ruled that the exclusion of the sales, when they were an integral part of their business model, would distort Nordania's partial exemption calculations, so they should not be seen as sales of capital goods used in Nordania's business.

Having reviewed *Nordania*, HMRC consider that the case overturns the High Court decision in *JDL v CCE* [2002] STC 1 and that the claims for output VAT on demonstrator cars did not take proper account of European case law on partial exemption.

As a result, the Revenue is asking businesses whose claims have not yet been paid to revise these to take account of the partial exemption implications.

Where claims have already been repaid without making adjustment for partial exemption, HMRC will be issuing recovery assessments.

Neil Warren, independent VAT consultant, said, 'This shows how complicated VAT becomes when many different topics overlap with each other, namely partial exemption, liability of sales and error adjustment periods. I am comfortable with the concept that the sales of ex-leasing vehicles should be within the partial exemption calculations.

'These vehicles are linked to customer use so are usually part of a clear business model, but demonstrator cars put to use by an employee is a different issue. I suspect there could be some complaints by the car trade... on these items being included.'

EMI Group Ltd v Revenue and Customs Comrs

The taxpayer was a company governed by English law and was engaged in the production and sale of recorded music and in music publishing. Since 1987, with a view to promoting its new recordings, it had been distributing free copies of those recordings on vinyl records, cassette tapes and compact discs (CDs) to various persons capable of assessing the commercial quality of the recording and of influencing the level of exposure which an artist received. In the context of that promotional strategy, such free copies were, inter alia, distributed to individuals working in the press, radio stations, television programmes, advertising agencies, retail outlets and cinemas. The taxpayer also used promoters, known as "pluggers", who were persons in a position to promote recordings in the audiovisual media and in the press, and who distributed those recordings, also free of charge, to their own contacts, targeted and detailed on lists specially compiled for the release of each new CD. For that purpose, the taxpayer supplied recorded music in a variety of forms, namely, recordable CDs protected by a digital watermark, which identified the name of the recipient and enabled any possible copies to be traced, for distribution prior to the release of the album; un-watermarked recordable CDs distributed in a white cardboard sleeve prior to the release of the album; conventional un-watermarked CDs distributed in a white cardboard sleeve detailing the same artwork as that which appeared on the final album intended for sale to the public; and CDs in their final form intended for sale. The latter had a sticker with the wording "Promotional Copy Not For Resale". The other types of recording distributed for promotional purposes had an inscription which stated that the property rights remained vested in the taxpayer. Approximately 90% of promotional CDs were sent to named individuals, the main exception being CDs sent to persons identified by their official position at a university or college. The number of potential recipients of free copies of recorded music, who were considered by the claimant to be influential in the music industry, was approximately 7,000. For the promotion of a given recording, a specific list of 200 to 500 recipients was compiled. That list would include the names of individuals thought to be most influential for the

promotion of sales of recordings of the particular type of music in question. When a new recording was about to be released, the taxpayer distributed, in general, between 2,500 and 3,750 copies free of charge. In the case of "pluggers", a single "plugger" might receive up to 600 free copies for redistribution. Conversely, copies might be sent separately to a number of persons working for the same organisation, such as the BBC. From April 1987 to June 2003, the taxpayer accounted for value added tax (VAT) on the copies of recordings distributed in the circumstances described. Subsequently, as it took the view that the national legislation was incompatible with the second sentence of art 5(6) of the Sixth Council Directive (EEC) 77/388 (on the harmonisation of the laws of the member states relating to turnover taxes – Common system of value added tax: uniform basis of assessment) (Sixth Directive), according to which, in its opinion, no VAT was payable in respect of such distributions, the taxpayer submitted a claim to the defendant Revenue and Customs Commissioners (the Commissioners) for reimbursement of the amounts of VAT paid in connection with those distributions. As the Commissioners rejected that claim for reimbursement, the taxpayer brought an action before the VAT and Duties Tribunal (the tribunal). Further, as the taxpayer ceased accounting for VAT on promotional distributions of free CDs from July 2003, the Commissioners sent it a tax assessment relating to those distributions for the period from July 2003 to December 2004, against which the taxpayer also brought an action before the tribunal. In those circumstances, the tribunal decided to stay the proceedings and to refer questions to the Court of Justice of the European Union for a preliminary ruling.

The questions were: (i) whether the term "samples" covered only goods given in a form not available for sale and covered only the first in a series of identical goods given to the same recipient; (ii) whether the second sentence of art 5(6) of the Sixth Directive had to be interpreted as precluding national legislation which imposed quantitative restrictions on the number or value of the gifts which might be received from time to time, or in the course of a fixed period, by the same person; (iii) whether, in the light of the application of certain ceilings, national legislation could treat gifts distributed by a taxable person to different individuals having the same employer as being gifts made to the same person; and (iv) whether the fact that the recipient of "samples", within the meaning of the second sentence of art 5(6) of the Sixth Directive, was a fully taxable person who would be able to deduct any input tax payable on the provision of goods consisting of samples had any bearing on the previous questions.

The Court ruled:

(1) A "sample", within the meaning of the second sentence of art 5(6) of the Sixth Directive, was a specimen of a product which was intended to promote the sales of that product and which allowed the characteristics and qualities of that product to be assessed without resulting in final consumption, other than where final consumption was inherent in such promotional transactions. That concept could not be limited, in a general way, by national legislation to specimens presented in a form which was not available for sale or to the first of a series of identical specimens given by a taxable person to the same recipient, unless that legislation allowed account to be taken of the nature of the product represented and of the specific business context of each transaction in which those specimens were distributed (see [40] of the judgment).

(2) The concept of "gifts of small value", within the meaning of the second sentence of art 5(6) of the Sixth Directive, had to be interpreted as not precluding national legislation which fixed a monetary ceiling of the order of that established by the legislation at issue, namely £50, for gifts made to the same person in the course of a 12-month period or forming part of a series or succession of gifts (see [45] of the judgment).

(3) The second sentence of art 5(6) of the Sixth Directive precluded national legislation which established a presumption that goods constituting "gifts of small value" within the meaning of that provision, distributed by a taxable person to different individuals having the same employer, were to be treated as having been made to the same person (see [50] of the judgment).

(4) The tax status of the recipient of samples had no bearing on the answers given to the other questions (see [53] of the judgment).

New deadline for EU VAT refund claims

The deadline for the submission of 2009 cross-border VAT refund claims has been extended by six months, following unanimous support by EU member states.

The move comes in response to EC proposal to allow more time, after become apparent that the VAT refund portals of a number of member states had not been functioning correctly. As a result, many businesses across the EU were in danger of not being able to submit their claims before the 1 October cut-off point.

While the UK VAT refund portal has suffered no problems, HMRC backed the EC proposal because some of the country's firms have either not yet been able to submit their claims to the appropriate member state of refund, or their claims have not yet been accepted into the other nation's portals.

The amended EU legislation – described by Baker Tilly's head of tax, George Bull, as 'very welcome' – is expected to be adopted early next month and will apply retrospectively from 1 October. The deadline extension means claims relating to 2009 will be able to be submitted at any time up to 31 March 2011.

Stamp Duty Land tax

LLP defined as body corporate

Where land transactions take place between members of a group, relief for stamp duty land tax (SDLT) is available (FA 2003, Sch 7).

A ‘company' for such purposes is defined in Sch 7 as a 'body corporate'.

HMRC have previously considered that a limited liability partnership (LLP) body corporate did not constitute a body corporate.

However, following legal advice, the department now accepts that, for the purposes of SDLT group relief, a body corporate does include an LLP.

An LLP can therefore be the parent in a group structure, but as it does not itself have issued ordinary share capital it cannot be the subsidiary of other companies.

This also means that any subsidiaries of the LLP cannot be grouped with the companies that are the corporate members of the partnership.

This revised view does not affect who can claim group relief, but does affect which entities are regarded as forming part of a group. An LLP cannot claim group relief itself because its chargeable interests in land are treated as held by or on behalf of the individual members (FA 2003, Sch 15 para 2), and this position is unchanged.

It also follows that if an LLP transfers land to a company that it owns, and that is within the LLP headed group, no group relief will be available as the land is deemed to be owned by the members of the partnership, and those members are not within the same group as the company owned by the LLP.

HMRC say they will not revisit the claim if SDLT group relief has been incorrectly claimed solely as a result of an LLP in the group structure being disregarded or looked through for the purposes of establishing group relationships.

With regard to group relief for stamp duty (FA 1930, s 42), HMRC now accept that an LLP, as a body corporate, can be the ultimate parent of a group for this purpose, although, as an LLP does not itself have issued ordinary share capital it cannot be the subsidiary of another company.

Transfers of stock and marketable securities may be made to the parent LLP from a subsidiary body corporate in the same group and qualify for group relief and vice versa.

Group relief cannot be claimed on the transfer of stock and marketable securities from a body corporate parent of an LLP to the LLP or to a body corporate subsidiary of the LLP.

HMRC confirm that as English limited and general partnerships do not have legal personalities separate from the persons who are the partners they must be 'looked through' when establishing bodies corporate that form a group for stamp duty land tax and stamp duty purposes.

As such companies that are partners of an English general or limited partnership can, depending upon the facts, be grouped with those companies that are below the partnership in the group structure.

Both Scottish limited and general partnerships have legal personalities separate from the persons who are the partners and cannot therefore be looked through when establishing bodies corporate that form a group.

HMRC are reviewing the group relief legislation for both SDLT and stamp duty to see how well it reflects the underlying policy aims on this changed view of LLPs.

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