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Personal Tax

Nine employment nightmares

Here are nine cautionary tales of things that may keep an employer awake into the early hours.

Nightmare 1: employment status

The question of who is and who is not an 'employee' has given HMRC, tax tribunals, employment tribunals and tax professionals many a sleepless night.

Recently, HMRC have turned their attention to the cunning witches (and some wizards) of Weight Watchers. This organisation can make their members disapparate gradually.

In this case (*Weight Watchers (UK) and others v HMRC* [2010] UKFTT 54) the status of class leaders, who had always believed themselves to be self employed, was considered and it was found that, on the balance of the facts, the class leaders were indeed employees of the Weight Watchers organisation. The contractual terms of the engagement were sufficient to demonstrate a mutuality of obligation between the parties, with HMRC citing S*tephenson v Delphi Diesel Systems Ltd* [2003] ICR 471 in support.

On the question of personal service, despite the existence of a contractual clause that permitted the class leader to send a substitute, the tribunal found that the relationship was formed on a meeting-by-meeting basis under an umbrella agreement, and if a substitute was used this was under a separate contract with Weight Watchers UK.

Therefore, the tribunal accepted HMRC's argument that a requirement for personal service existed. Points of control also tended to support HMRC's view.

As we write, this case is under appeal and it demonstrates that the subject of employment status has not gone away and thus its potential to cause a nightmare is up there with strong cheese and scary films.

Nightmare 2: the salary sacrifice

It is a clever spell which enables employers to provide their employees with benefits in exchange for a reduction in gross salary. Like all spells, though, it is the wording and the way that it is expressed which affects the outcome.

The nightmare scenario happens when the spell is inaccurately expressed or executed and tax is due not only on the benefit, but on the original salary as well. How can this be prevented from happening, short of a course in transfiguration?

Salary sacrifice is a legal process, which requires the employee to make a change to the terms and conditions of employment. That change must be irrevocable and has to be effective before the right to receive the original amount crystallises.

Usually, HMRC will accept that an annual review of salary sacrifice will not prejudice the 'irrevocable' condition and most flexible benefit schemes will allow employees to make in-year changes when certain 'lifestyle' triggers occur.

These might include marriage or civil partnership, the birth of a child, or the redundancy of a spouse or civil partner. There is, however, some relaxation around the timing of changes for childcare vouchers which allows greater flexibility.

HMRC are officially 'agnostic' about salary sacrifice. However, we sense an ominous wind of change. The anti-forestalling rules around the restriction of tax relief for pension contributions instruct employers to disregard any amounts sacrificed when calculating an employee's income level.

Furthermore, from April 2011, ITEPA 2003, s 317 has been changed to restrict the exemption for the benefit of free or subsidised meals if an employee has an entitlement in conjunction with salary sacrifice or flexible benefits arrangements.

Where an employee agrees to give up some of their salary in exchange for the provision of food and drink, HMRC say that this is now merely an allocation of gross income and therefore the exemption to employer-provided meals contained elsewhere in ITEPA 2003, s 317 will no longer apply.

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HMRC will not give advance clearance for a salary sacrifice scheme, but do have a special clearances team based at Southend-on-Sea who will review an existing scheme and give an opinion as to its robustness for tax purposes.

All spells have the potential to backfire and salary sacrifice is not exempt. For example, an employee may not make a salary sacrifice which reduces the salary below the national minimum wage (currently £ 5.93 per hour for workers over 21 years of age).

Reducing gross salary by entering into a salary sacrifice may have a knock on effect on income-related state benefits and on mortgage or loan applications. Be warned: an added complication arises during maternity or adoption leave, where the employer is now legally obliged to continue to pay non-cash benefits although there may be no salary from which to offset the cost for the employer.

In summary then, salary sacrifice requires careful handling but can still be very useful to the sensible employer.

Nightmare 3: unexpected dividends

An Upper Tribunal (Tax and Chancery Chamber) has confirmed that dividends paid to a company's employees under a discretionary bonus scheme, involving a third-party company, were subject to National Insurance.

In *PA Holdings Ltd* [2010] UKUT 251 TCC, the company set up a discretionary employee bonus scheme. Under the arrangement, the company transferred funds into an employment trust, which then purchased shares in another company, and in a series of steps the shares in the third company were then awarded to employees. The shares carried rights to a single dividend and no voting rights.

HMRC challenged PA Holdings on the tax and National Insurance treatment of the income from these third-party dividends in the employees' hands.

The First-tier Tribunal judge said, 'One of the most important unwritten rules of income tax is that income generally can be taxed only once' and held that the payments were to be treated as employment income.

However, the payments also constituted dividends or distributions and while they were not chargeable under the PAYE system, they were earnings that were subject to liability for Class 1 National Insurance.

HMRC appealed seeking to apply the *Ramsay* principle (WT Ramsay Ltd v CIR [1981] STC 174) in order to unpick the scheme and apply PAYE. The taxpayer also appealed on the grounds that the payments were not earnings and so not subject to National Insurance. The Upper Tribunal threw out both arguments and so the First-tier Tribunal decision prevails.

Nightmare 4: a visit from HMRC

A knock on the door in the quiet of the night – even the most innocent tend to get sweaty palms at the prospect of a HMRC visit. A recent addition, as part of HMRC's review of powers, is the concept of a business premises visit in real time: i.e. before a return has been submitted. This can be a pre-arranged visit with seven days notice or even be unannounced.

HMRC have recently issued some compliance check factsheets, setting out what they can do, what they can't do, and what to expect.

Nightmare 5: simple mistakes

Each year HMRC provide details of common errors by employers when submitting end-of-year returns. These include everything from sending in the wrong form to incorrect references.

Nightmare 6: expenses

The quirky UK rules concerning what expenses are or are not deductible frequently create headaches. Any employee wishing to obtain relief for certain expenses has to overcome the tough hurdle of satisfying the 'wholly, exclusively and necessarily' test.

This is now found in ITEPA 2003, s 336(1), where it notes that: 'The general rule is that a deduction from earnings is allowed for an amount if:

> (a) the employee is obliged to incur and pay it as holder of the employment; and (b) the amount is incurred wholly, exclusively and necessarily in the performance of the duties of the employment.'

The expenses have to be inherent in the employment itself and not particular to any individual employee. Unfortunately, a contractual obligation to incur the expenses is also not enough because the incurring of the expenses must be intrinsic to the actual carrying out of the employment duties.

This has made it very difficult for employees to claim items like training expenses. The *Banerjee* case [EWCA Civ 843] does give some hope here although will not work in all cases. The issue was whether a specialist registrar in dermatology was entitled to claim a deduction for attending specialist education training courses and conferences.

Dr Banerjee succeeded on the ground that her attendance at these training courses was specifically included in her contract of employment. Evidence was also provided by other doctors stating that attendance at training courses was compulsory.

But what of an employee who wants to deduct a clothing item? A recently reported First-tier Tribunal decision concerned Sian Williams, the BBC1 anchorwoman (*Ms S Williams v HMRC* FTT [2010] UKFTT 86 (TC397).

Ms Williams argued that she should be able to claim a deduction for the clothes and hair styling costs required to be on national TV. This amounted to an annual cost of about £4,500.

The tribunal dismissed her claim on the basis that she wore clothes that, although smart, were not that dissimilar to those that she would wear when 'off-duty'. Ms Williams captured the headlines with the argument that:

'She does not need the clothes for warmth as it is warm inside the studios, and that she would be prepared to read the news without clothes and only wears the clothes because her employer requires it.'

The tribunal remained unconvinced and her claim failed, but on the bright side the viewing figures probably rose.

Nightmare 7: company cars

With relentless changes and a squeeze on how tax effective a car can be, the frequent question for an employer is around how a vehicle may be provided in a way that is beneficial for both the employer and employee.

Take Mr Big, the owner and director of a company, who wants to change his company car, which is primarily used for business but also has some private usage. The company does not pay for his private fuel.

He picks out a car with a list price of £42,000 and carbon dioxide emissions of 287g/km. There is a special price discount to cover slow sales so £10,000 is knocked off the price.

The tax payable personally by Mr Big for the provision of the car is based on the original list price (ignoring the discount) and amounts to £5,880 annually at 2010/11 rates. The tax relief gained by the company for buying it is based on the actual sales price (£32,000) and is therefore only £672 in the first year (assuming the company is 'small' for corporation tax purposes) and less for the following years.

As can be seen above, there is something equivalent to a £5,000 tax loss for every year the company owns the car. Instead, Mr Big could own the same car personally. The company could pay him a dividend to buy the car. The tax here would be a on-off charge payable by the director of £8,000.

Of course, the facts are crucial in these types of cases and you need to look at the CO2 emissions to see the best route forward. For those looking at much 'greener' cars (under 110g/km emissions) the car benefit can still be very reasonable and 100% first year allowances are available.

Nightmare 8: PAYE changes

Just keeping pace with the never ending legislative change can give employers the creeps. After a year of hard-hitting headlines about HMRC's end of year PAYE reconciliations, another pressing issue is how PAYE may change in the future.

The new government is looking at making PAYE data collection happen in 'real time'. A review and consultation was announced in the 22 June 2010 Budget with a view to examining how the system could be improved to reduce costs 'and make the system easier for employers and HMRC to administer'. Broadly, that means moves towards real-time data collection.

The current system was designed for a world of relatively stable employment patterns. HMRC have identified the problem that many more people have an under or over-payment at the end of the tax year, which creates extra work for HMRC and unexpected surprises for employees.

The solution suggested is that employers should report payments of earnings and deductions each time a payment is made. It would mean that code changes could be made more promptly and be based on up-to-date information if there was regular electronic contact and processing of income data, reducing the likelihood of incorrect deductions.

Clearly, this can only work if the technology is up to it. The new National Insurance and PAYE Service (NPS) enables the creation of a single tax account for each individual that includes employment, earnings and contact history and the National Insurance record.

But it is still a challenge to move to speedier information exchange, although there is much to suggest it is a sensible way to go.

The scarier part of the discussion document relates to a radical option called 'centralised deductions'. This would see HMRC calculating the PAYE, National Insurance and student loan deductions concerned.

Employers and pension schemes would continue to supply data on income payments due, and HMRC's computers would hold it in a real-time tax account for each taxpayer. HMRC's computer would then calculate the correct deductions and advise the payers electronically how much to withhold.

Given the many and varied recent experiences concerning HMRC and information technology this concept may be a bridge too far at the current time. We will need to see what the Government decides on the next step forward.

We understand that there were an unusually large number of responses, which have brought many practical issues to light. It seems likely that HMRC's next step will be to go to formal consultation.

We fear that this is one nightmare that won't go away – not yet, anyway.

Nightmare 9: missed opportunity

And what does the above prove? As Shakespeare said (but not in a play populated with witches): 'Or in the night, imagining some fear, how often is a bush supposed a bear?'

The biggest nightmare for employers is what they fail to spot, prepare for, or take advantage of in good time.

It is the tales of the unexpected and a fear of the unknown that will send shivers down the spine. Things never look so frightening in the clear light of day; and of course that's where tax advisers can come in to help employers sleep soundly at night.

Contributed by Ellie Gamble and Francesca Lagerberg, Grant Thornton

Lecture B627 (9.13 Minutes)

Some things to think about for higher earners

Introduction

For high net worth individuals, the spate of recent tax changes could be giving them a sense of paranoia. Add together the tapering off of the personal allowance, the new 'super' tax of 50%, NIC increases and pension restrictions there is much for them to consider.

Example

Take a married couple with one earner and two children. There is income of £1m (£500k salary and £500k bonus) and a pension contribution of 16% of salary (£80k). The following are some items they will need to consider in terms of 'extra' tax hits making a few assumptions about what will happen over the next 12 months.

2010/11

50% tax rate	70,000
Withdrawal of personal allowance	2,590
	£72,590

2011/12

1% increase in NICs	9,620
Reduction in basic rate band	500
Pension allowance charge	15,000
	£25,120

Below are just some items that you might want to be talking to a high net worth about over the coming months.

1. Income tax - 50p taxpayers

The 50% income tax rate for those with income over £150,000 is a high agenda item for many entrepreneurs especially those who need to extract profits from a company, where the effective tax rate can be around 54%.

- Shareholders of privately owned companies could consider planning to extract funds of £3m or more as capital gains rather than income, thus benefiting from a tax rate of between 10% - 28% (or less if the base cost of the shares is high or personal capital losses are available) rather than an effective rate of 36% on a dividend.
- Investment assets in a company such as property could be moved into a structure which enables the capital gains tax (CGT) rates (up to 28%) to be accessed on any future growth (as compared to 54%). This can be achieved without crystallising any tax charges and without necessarily disrupting existing finance arrangements, thereby saving 26% tax.
- Consider making investments where the return is structured as capital and subject to CGT, at maximum rates of 28% rather than an interest return, taxable at rates of up to 50%. Whilst the differential in capital gains tax and income tax rates is no longer as great, if this can be achieved, it still provides a tax saving of 26%.

2. Capital gains tax

From midnight on 22 June 2010, the rate of CGT increased from 18% to 28% for individuals whose income and gains exceed the basic rate band (currently £37,400), trustees and non-domiciled individuals paying the £30,000 remittance basis charge. There was also an increase in the lifetime limit for entrepreneur's relief from £2m to £5m.

The new 28% rate seems to have been favourably received but only against fears of a 40% or even 50% rate.

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For many, 28% will be too high especially when taking into account inflationary gains, so what are the options for these taxpayers?

- Review the allocation of investments between spouses and civil partners to make maximum use of annual exemptions and basic rate bands.
- Entrepreneurs should consider whether their business interests currently meet, or could be adjusted to meet, the conditions for entrepreneur's relief. The conditions need to be met for a period of at least twelve months prior to sale, so review your position now to ensure you can take advantage of a potential tax saving worth up to £900,000.
- Consider also whether business interests can be restructured so that spouses and civil partners (or other family members) could also benefit from entrepreneur's relief, which could double the tax saving to £1.8m. The requirement to be an officer or employee is not particularly onerous and a director of a dormant subsidiary may well suffice.
- Entrepreneurs selling their businesses for more than £5m, will be worse off following the introduction of the 28% CGT rate and for those with a greater appetite for tax risk, there are planning opportunities to secure a 0% CGT rate. These are not for the faint hearted.
- Those willing to leave the UK for at least five complete tax years, may be able to sell their businesses whilst non-UK tax resident, thereby avoiding UK CGT. If they leave the UK, other than under the full-time work abroad rule or the full year out rule, they need a distinct break with the UK and social and family ties with the UK need to be severed. Clearly they need to check their tax position in their new country of residency.

3. Inheritance tax

There were no changes to inheritance tax (IHT), with the nil rate band remaining at £325,000 and the rate at 40%. The main concern continues to be inflation, which will erode the real value of the nil rate band, which means that more estates will fall into the IHT net.

So, what can be done to protect and maximise wealth for the next generation?

- Business Property Relief (BPR) is still a valuable relief at either 50% (e.g. business premises owned outside of a company) or 100% (e.g. shares in an unquoted trading company). It is worth reviewing your business assets to ensure that they do qualify.
- With careful structuring it may be possible to engineer BPR for investment assets in a company which would not normally qualify for BPR..
- Entrepreneurs wanting to set aside a fund for children/grandchildren should seek advice prior to a sale of the business, as this may be a great opportunity to transfer assets into trust without incurring an immediate IHT charge on any amounts above £325,000 (subject to consider the impact on other taxes and in particular, entrepreneur's relief).
- On a sale for cash/loan notes, an asset which qualified for 100% BPR is effectively replaced with an asset which is subject to IHT at 40%. There are a number of planning strategies which mitigate this IHT charge, whilst at the same time enabling the individual to retain control of the assets and to have access to the income and capital for life.

4. EFRBS

Employer Financed Retirement Benefit Schemes (EFRBS) gained popularity following the Government's restriction of tax relief for higher earners in the Finance Act 2009. However, the Government's announcement on 14 October 2010 casts doubt on whether EFRBS will continue in their existing form from 6 April 2011.

EFRBS allow employers to provide retirement benefits to their executives with fewer restrictions than traditional company schemes, as well as providing a tax-efficient structure for both employee and employer.

Current advantages of an EFRBS

- No restrictions on contributions or benefits (as apply to registered pension schemes)
- Employer contributions are not taxable as remuneration in the hands of the employee
- Employer contributions are not subject to UK National Insurance
- Any contributions made to the EFRBS obtain a deferred corporation tax deduction, which is triggered upon extraction of benefits (which could be many years later)
- If the EFRBS is structured offshore, the fund can accumulate mainly tax-free (except for tax on UK source income)
- There are generally no restrictions on EFRBS investments
- The whole fund to be taken as cash (net of income tax at the appropriate rate).
- Can have inheritance tax advantages.

Why is the Government looking to review EFRBS planning?

On 14 October 2010 the Treasury outlined new provisions restricting tax relief on pension contributions. At the same time, it was confirmed that new legislation will be introduced with effect from 6 April 2011 to ensure that intermediary vehicles such as EFRBS are less attractive than other forms of remuneration. The Government stated that it wants to prevent EFRBS being used as a vehicle to disguise remuneration and avoid, reduce or defer income tax and National Insurance. Draft legislation is to be published towards the end of 2010. This was partly triggered by various comments about 'aggressive' use of EFRBs (eg various newspaper articles about professional footballers).

The Government confirmed that EFRBS should not provide greater tax benefits than registered pension schemes for pension savings above the proposed new annual allowance of £50,000. Pension contributions to registered schemes made up to this level will benefit from income tax relief at the individual's marginal rate of tax but any contributions in excess of this level will not qualify for tax relief.

Will EFRBS continue to offer flexibility and tax efficiency?

The detail of the anti-avoidance measures remains to be seen but one thing is certain, there will be much speculation over the next couple of months and the key questions will be:

1. Will EFRBS established prior to 6 April 2011 be adversely affected by the proposed changes?
2. Will EFRBS established on or after 6 April 2011 confer any tax advantages on companies and individual taxpayers?

The draft legislation will be eagerly anticipated in order that these questions can be answered.

Contributed by Francesca Lagerberg

Lecture P626 (8.46 Minutes)

Cars made available to directors and an executive box at football club

In *Frank Hudson Transport Ltd v HMRC*, a family company (F) purchased two cars from a finance company under a hire-purchase agreement, and made them available to its controlling directors. HMRC issued a ruling that income tax was chargeable under ITEPA 2003 s 114. The First-Tier Tribunal dismissed F's appeal on this point, holding that the cars had been 'made available' within s 114. F had also hired an executive box at a League One football club. The son of F's controlling directors played for the club. HMRC issued a ruling that this was a benefit in kind for the directors, and that income tax was chargeable under ITEPA 2003 s 203. F appealed, contending that the box had been hired to entertain customers, and that the directors did not need to hire the box in order to see their son play, as they could have obtained free tickets from their son. The First-Tier Tribunal

accepted this contention and allowed F's appeal on this point, holding that the hire of the box was not a 'benefit in kind' for the directors.

The decision on the scope of ITEPA 2003 s 114 seems to be clearly predictable, but the decision on the hire of an executive box at a League One football club is an interesting one which shows the value of presenting specific evidence. Normally HMRC would regard the hire of an executive box as the provision of a benefit in kind. The unusual feature of this case was that the directors' son actually played for the club, so that the directors could have obtained free tickets to watch him play, indicating that the decision to hire a box was therefore to provide hospitality for the company's customers.

Company cars and family members

A recent tribunal case (*S Barnard Ltd v HMRC*) concerned a BMW car provided to the company secretary, wife of the controlling director. The company contended, unsuccessfully, that this was normal commercial practice and the benefit-in-kind should be taxed and charged to NIC directly on the wife, rather than on the husband (as provision to a family member).

Evidently, the wife was not a director herself. The car benefit (and fuel benefit) – together with any small salary – may have fallen below £8,500 and thus if taxed on the wife would not be taxed at all (as a low-earning non-director). The legislation is designed specifically to catch, inter alia, just this sort of situation.

Note, however, that in other circumstances if the planning aim was simply to pay a lower rate of income tax (assuming the wife’s marginal rate is less than the husband’s) the solution would be – commercial requirements so permitting – to simply make the wife a director so that the benefit is taxed on her in her own right and not on someone else as a family member. On this occasion the overall Class 1A NIC paid by the company would, of course, be the same either way.

Peter Arrowsmith writing in Taxline, November 2010

Cude v Revenue and Customs Comrs

In September 2000 the appellant and his wife purchased the Post Office for £69,950 and the appellant entered into a contract with Post Office Ltd to become the subpostmaster. On 9 April 2002 Post Office Ltd wrote to the appellant giving details of a network reinvention programme, and informing him that his branch could be involved in a possible closure. The letter contained details about possible compensation to be given and concluded “… we have proposed that any subpostmaster leaving the network would receive a payment equivalent to 28 months of their remuneration.” The appellant replied that he would sell the business and the “Details of Sale” were produced on 2 May 2002 which stated: “Price: £75,000 and Post Office Salary £33,750.” On 12 March 2003 Post Office Ltd set out an alternative method of calculation of compensation based upon “… what you paid for the business …” with that alternative method compared with the original method and the level of compensation offered set at the lesser of the two amounts. Then on 27 May 2003 Post Office Ltd wrote to the appellant indicating that the business value method was taking longer to process and proposing a fixed sum based on a sliding scale, with the offer to be made at £32,363.22. The appellant replied indicating that he opted for the business value compensation. Post Office Ltd made a conditional offer to the appellant “in the sum of £75,107.71 in relation to the closure of [his] branch.” At that point the issue of tax was raised—chargeable under TA 1988 s 148 and attracting the exemption (up to £30,000) contained in Sch 11. The appellant accepted the offer and did not ask what part of the compensation offer might be subject to tax because he did not consider that any part of it was for loss of office but only for loss of business. On 7 June 2004 the branch was closed and the appellant was sent an undated “Pay Advice” which recorded a network re-invention payment of £75,107.70. It did not mention the words compensation or loss of office. The issue arose as to the correct tax treatment of that payment. The appellant argued that the whole of the termination payment should be treated as a capital payment to his wife and himself in equal shares in respect of their disposal of the goodwill of their partnership business upon closure. The payment was not employment income for the following reasons: (i) the standard contract included a clause that no compensation could be paid to a subpostmater for loss of office; (ii) the correspondence referred to compensation for loss of business and investment, and the phrase compensation for loss of office

was not mentioned. The money should be seen as compensation for loss of business and investment; (iii) he resigned voluntarily and could not therefore be compensated for loss of office; and (iv) (as accepted by HMRC) the tax treatment of any payment did not depend on how the payment was calculated but rather on what the payment was for and therefore any references to 28 months remuneration did not affect the status of the compensation. HMRC submitted, inter alia, that, subject to the £30,000 exemption under TA 1988 s 403, the payment counted as employment income of the appellant under ITEPA 2003 s 401 as (i) the compensation offer was not made under the terms of the standard contract but under the terms of the network reinvention programme; (ii) the correspondence showed that the compensation was likely to have been compared in the final stages to a figure based on remuneration. In the absence of a calculation showing that all of the compensation offered was based purely on the loss of business and investment, it was for loss of office; and (iii) the appellant was allowed to resign voluntarily but he did so because he was offered compensation in connection with his loss of office.

The tribunal found that when the appellant agreed to close his Post Office branch he then lost his position as a subpostmaster and the ability to sell the goodwill attached to that position. The compensation was offered to cover those losses, ie it was paid either for the loss of office or in connection with the loss of office. The compensation was not intended to compensate directly, pound for pound, for loss of business and investment. A subpostmaster who had paid more than the business was worth was not likely to be compensed for his investment in the business in the first place. The capping of 28 months remuneration was intended to reflect that. The £75,107.61 compensation paid to the appellant was received directly or indirectly in consideration or in consequence of or otherwise in connection with his loss of office and was received by him in his capacity as a partner with his wife in partnership. Under ITEPA 2003 s 401(1), all of it was classed as having been received by the appellant and subject to a £30,000 exemption under s 403, the remaining £45,107.61 was subject to tax as employment income of the appellant. It followed that the appeal would be dismissed.

Appeal dismissed.

Total People Ltd v Revenue and Customs Comrs

The appellant company placed apprentices and other trainees with employers and supervised their training at their place of work which involved a great deal of travelling for its training advisors. The appellant paid the training advisors' travelling expenses as a mileage allowance payable at a rate per mile (40 pence per mile), or as a smaller mileage of 12 and later 13 pence per mile plus an annual lump sum payable in monthly instalments. The appellant's contracts of employment did not show the lump sum payments as part of the salary, and increases in the lump sum payments were not linked to any increase in staff salaries. The appellant structured the payments in that way because it considered that a 40 pence per mile structure risked encouraging staff to maximise their travel so as to maximise their profits, which they might have perceived they could make from the 40 pence payments, and it was administratively more convenient. The appellant paid national insurance contributions ('NICs') based on the lump sums. However it subsequently submitted a claim for the repayment of those amounts on the grounds that the payments were relevant motoring expenditure ('RME') for the purposes of the Social Security (Contributions) Regulations 2001, SI 2001/1004, reg 22A, as amended. Regulation 22A(1) stated that “To the extent that it would not otherwise be earnings, the amount specified in paragraph (2) shall be so treated.” The amount within para (2) was the RME—as defined in para (3)—less any qualifying amount ('QA')—as specified in para (4)—and any amount falling within para (2) was treated as earnings if it would not otherwise be so treated. Under para (4) the qualifying amount was the number of miles of business travel times the current rate (which was 40 pence per mile) and so, as the amount on which NICs were payable was the RME less only the QA; the result was any mileage payment more generous than 40 pence per mile would still attract NICs but only to the extent that it exceeded 40 pence per mile. HMRC rejected the repayment claim on the basis that the lump sums paid to the staff should have been ignored because they were paid as part of their wages and so fell outside the RME in reg 22A and therefore NICS were payable on them. The appellant appealed.

The tribunal found on the evidence that the lump sum payments were paid as motoring expenditure. The absence of a link between the increase in salary and increase in the motoring allowances, and the rationale for structuring the payments in the way that the appellant did, were significant factors

pointing towards that conclusion. The payments were not additions to salary and were not paid as earnings. As a result they were part of the RME. It followed that the appeal would be allowed.

Appeal allowed.

Employer Supported Childcare from April 2011—Guidance for Employers

Introduction

HMRC has published questions and answers on changes to employer supported childcare that will affect new joiners from 6 April 2011.

From 6th April 2011 there will be changes to Employer Supported Childcare that will affect employers who operate a childcare voucher scheme and/or directly contracted childcare. There are no changes to workplace nurseries schemes.

Aim of change

Under current arrangements, employees on higher earnings receive a greater tax saving than those who pay tax at the basic rate. The change evens out the amount of tax saving available for all employees regardless of the rate that the individual pays tax.

These changes will mean that anyone who joins an employer supported childcare scheme from 6th April 2011 will receive the same level of income tax exemption, which is approximately £11 per week.

Employees affected

Employees who already participate in an employer scheme on or before 5th April 2011 are not affected by these changes unless they leave the scheme or your employment.

Employers must carry out a basic earnings assessment to check the estimated employment income of any employee who joins a scheme on or after 6th April 2011. The amount of exempt income (in the form of childcare vouchers or directly contracted childcare) that the employee can subsequently receive will be determined by the result of the basic earning assessment.

There is no need to make an assessment for existing employees who were already participating in an employer's scheme on or before 5th April 2011. Annual renewal of agreements between employers and employees are fine.

Exempt amounts from 6th April 2011

The table below sets out the amounts that can be provided to employees as exempt income:

	Basic rate	Higher rate	Additional rate
Weekly	£55	£28	£22
Monthly	£243	£124	£97
Annual	£2915	£1484	£1166

The Basic Earnings Assessment

From 6th April 2011 the basic earnings assessment should be carried out when an employee first joins an employer's scheme and then annually at the start of the tax year.

It is an assessment made on the information available at the start of the tax year on earnings that are expected for the current year from that employment only and using the employee's allowances based on their tax code.

Employers must keep a record of the basic earnings assessment calculation. They must contain sufficient information to show how the individual's basic earnings assessment has been calculated.

Earnings and benefits to be included in the basic earnings assessment

The basic earnings assessment should include the following information—

Basic pay as stated in the employee's contract of employment.

- Contractual or guaranteed bonuses.
- London weighting or other regional allowances.
- Taxable benefits.
- Shift allowances.

Excluded earnings and benefits

- Performance related or discretional bonuses.
- Overtime payments.
- Earnings and benefits that are exempt from tax such as pension contributions, employee share schemes and payroll charitable donations.

What happens if the employer gets the basic earnings assessment wrong?

If the employer has based the assessment on the best available information at the time the assessment is carried out, then it will be valid for a full twelve month period until the next assessment is carried out. Any exempt figure used as a result of this assessment will be treated by HMRC as correct for P11D purposes.

If the employer gets the initial assessment incorrect due to a failure to use relevant available information and the employee has received a level of relief they were not entitled to, HMRC can assess for any additional tax that is payable. An employer can also report the additional benefit paid by submitting a form P11D.

Employer and Employee NICS

These are the amounts that employers and employees can receive free of NICs in the form of childcare vouchers or directly contracted childcare from 6th April 2011. These amounts apply only to those employees who join on or after that date and have bee subject to a basic earnings assessment.

If the employee has already joined the employer's scheme on or before 5th April 2011, the NICs free amount remains at £55 per week for childcare vouchers and directly contracted childcare. There is no limit for workplace nurseries.

	Basic rate	Higher rate	Additional rate
Weekly	£55	£28	£22

The earnings assessment that employers are required to undertake at the start of the employment or tax year for income tax purposes will apply equally for NICs purposes.

If the value of the childcare vouchers that an employee is provided with is more than the NICs free amount, the excess will need to be added to any other earnings the employee is to receive in that pay period and NICs calculated on the total earnings figure. If more than the NICs free amount of directly contracted childcare is provided the excess will need to be reported on the P11D for both tax and Class 1A NICs purposes.

Taken from HMRC Guidance Note 28 October 2010

Lecture P628 (14.23 Minutes)

Pension reforms: Are QNUPS the cure?

The new pension rules mean that from 6 April 2011 the annual allowance afforded to a UK resident saving for his pension will reduce significantly from the current £255,000 to £50,000. This relief will continue to be given at the taxpayer's highest marginal rate (so possibly at 50%).

Where an individual exceeds the annual allowance the excess will be liable at his highest marginal rate. The lifetime allowance will be reduced from £1.8 million to £1.5 million and where an individual exceeds the lifetime allowance the excess will be liable at 62.5%.

This is a huge disincentive and is likely to deter the accumulation of funds in excess of the lifetime allowance.

Unfortunately, the threat of imminent reviews and the possible tightening or curtailing of the legislation and practices governing employer-financed retirement benefit schemes (EFRBS) and similar employer-funded schemes, suggest that anyone wishing to continue to save significant sums in a pot to provide a higher than average income for life and who was considering using or was, in fact, using these vehicles, may struggle to achieve his aim and may be thwarted in an attempt at alternative pension planning.

So does a 'QNUPS' arise out of the ashes and present a panacea to all pension planning problems?

Qualifying non-UK schemes

A QNUPS is a qualifying non-UK pension scheme while a QROPS is a qualifying recognised overseas pension scheme. There are many overlapping criteria when comparing QNUPS and QROPS.

Both must be established in a territory and in such a manner that it will be recognised as a pension scheme in that territory. Alternatively, provided the scheme is recognised as a pension scheme for tax purposes in the territory where it was established and it meets conditions set out in the QNUPS regulations, the need to be recognised as a pension scheme should not be problematic.

QROPS versus QNUPS

The major difference is in respect of HMRC reporting.

A QROPS must register with HMRC under the provisions of the Pension Schemes (Information Requirements – Qualifying Overseas Schemes, Qualifying Recognised Overseas Schemes and Corresponding Relief) Regulations SI 2006 No 208, Reg 3, before any transfer can be made into it from a UK scheme and the trustees must commit to reporting unauthorised payments and similar events for a period of five years after the member has become non-resident in the UK.

In certain circumstances, the necessity to continue reporting to HMRC may continue after the five-year period, depending on the investments held or the payments being made.

On the face of it, there are no similar reporting requirements for a QNUPS.

The schemes and tax differences

A QNUPS, which is a vehicle for all intents and purposes that mirrors a QROPS, but has not registered with HMRC, can receive contributions from the member in the UK, but cannot receive inward transfers tax-free from a UK scheme.

No UK tax relief is available on these contributions. Nor can it receive tax-free contributions from a company in the UK. For a UK resident individual, therefore, it should not be used in planning involving an existing pension scheme.

However, a QNUPS can be used as a standalone pension pot.

In summary:

- the offshore pot is not subject to IHT either on creation or in subsequent years (unlike a trust);
- the transfer of assets into a QNUPS could be a chargeable occasion triggering a CGT charge at either 18% or 28%.

- gains and income (if investments are planned properly) can roll up tax free; and
- the only tax charge appears to be that on extraction of the pension, and even then the whole amount may not be taxed;

Settlements provisions

Where a QNUPS was created specifically with the bounteous intent of leaving assets to future generations, HMRC could contend that the settlement provisions would apply. This could have a similar capital gains tax implication also.

The downsides

There may be limitations placed on the level of contributions that can be made under the terms of the domestic legislation under which the QNUPS is formed.

The scheme would be subject to tax charges or reliefs according to the legislation which governed the taxation of the local resident.

So for example, in the Isle of Man, the contribution ceiling is £300,000 (or 100% of earnings) but there was a disincentive to establish a QROPS or QNUPS there as the pension payments taken from a Manx pension scheme were subject to income tax at a rate of 20% in the Isle of Man.

Recent developments

In an effort to position themselves for the QROPS and QNUPS markets, Guernsey and the Isle of Man have revised or set out proposals to amend elements of their domestic legislation which proved a disincentive to potential investors.

On 19 October 2010, the Manx parliament passed a law to enable the creation of a new form of pension scheme (a '50c' scheme) which will satisfy all criteria necessary to be a QROPS (QNUPS).

The new pension scheme became available on 22 October 2010. Previously, Isle of Man companies had created pensions under Guernsey law to facilitate QROPS planning.

Furthermore, the Manx government removed the charge to income tax on pension payments, provided the recipient is not a resident of the Isle of Man.

On 20 October 2010, Guernsey's Treasury and Resources Department issued proposals for amendments to Guernsey's domestic legislation affecting pensions.

Most notably, the proposals include the removal of a monetary limit on amounts which can be contributed to an occupational or private pension scheme.

For Guernsey resident individuals there will be a cap on tax relief and this will be the lower of 100% of relevant earnings or a monetary amount, still to be agreed, but which could be between £35,000 and £50,000. For non-Guernsey residents, however, there will be no limit on the amount which may be contributed.

The proposals will be heard by the States of Guernsey on 24 November 2010. Any monetary limit placed on tax relief for contributions by Guernsey residents will be decided subsequently.

Alison Vine writing in Taxation

Lecture P627 (9.38 Minutes)

Employees urged to consult staff on canteen arrangements

HMRC have published three questions and answers for employers about the new rules that apply from 6 April 2011 for salary sacrifice and canteen arrangements.

First, with regard to existing arrangements, HMRC say they will continue to challenge arrangements that they consider may not be effective, on a case-by-case basis. The legislation does not affect the arguments that the Revenue has been running in existing compliance cases.

Second, it has been suggested that the April 2011 commencement date for the FA 2010 change gives some employers, who may have ineffective arrangements, time to review their arrangements while other employers remain the target of HMRC compliance.

In this respect, the department says the start date is intended to give employers with effective existing arrangements reasonable time to consult their employees, consider their options and make changes to their arrangements, if they so choose. It is not a period of grace for all employers with existing arrangements.

The Revenue says it will continue to subject employers to technical challenge on the basis of the current legislation where it considers that arrangements are not effective.

The third question looks at circumstances when HMRC would accept that existing canteen arrangements are effective. They say that, as explained in *Employment Income Manual* EIM21675, arrangements do not result in the employee having earnings where the employee loses the value of any free or subsidised meal that he could have had on a day when he chooses not to access the canteen.

NIC holiday: more detail

In the June 2010 Budget, the Government announced a holiday from employer's National Insurance contributions (NICs) for new businesses. HMRC published more details about this on 27 August in the form of a Technical Note: Regional Employer NICs Holiday for New Businesses.

In particular, HMRC confirms that the scheme will indeed commence on 6 September 2010.

Below the ICAEW Tax Faculty summarise the terms of the NIC holiday and explain what's in the latest Technical Note.

HMRC has also published guidance for new businesses, including an application form.

The NIC holiday – a summary

This will be a three-year scheme available to qualifying new businesses set up on or after 22 June 2010 outside London, the South East and East England.

It provides exemption from up to £5,000 of Class 1 employer NIC for each of the first 10 employees hired in the first year of business. Each holiday will last for the first 52 weeks of each employee's employment, providing these fall within the three-year holiday scheme period.

Most kinds of business activity (including investment and property businesses) will be eligible for the holiday provided they employ staff and meet other criteria, but some will be excluded.

Most staff will be included but there will be some specific exclusions, for example employees operating under companies caught by the IR35 rules and employees engaged through managed service companies.

Businesses which meet the criteria and which start up between 22 June and the time the holiday scheme starts will have to pay employer's NIC in the period before the start of the scheme but will receive a holiday of equal duration once the scheme starts.

What's in the Technical Note?

The Technical Note: Regional Employer NICs Holiday for New Businesses sets out how the scheme will operate. It includes draft clauses and draft Explanatory Notes.

The Tax Faculty is most grateful to NIC expert and Faculty volunteer Peter Arrowsmith for providing the following list of key points. These bring out the information in the Technical Note which add to the basics that were announced in June.

1. The legislation is not expected to receive Royal Assent until early 2011 so if for any reason the NIC holiday is never, in the event, enacted, any relief already obtained will be repayable as extra Class 1 NICs by 19 April 2011.
2. There are anti-avoidance rules as to the meaning of a new business. And a business already claiming the holiday which is then taken over or sold will cease to be eligible immediately.

3. The geographical areas have been confirmed. Peter Arrowsmith says: For example the 'Eastern Region' does not include my own Northamptonshire, but does include Bedfordshire (about two miles down the road as I sit here now). It still surprises me that the remoter parts of Norfolk – to take just one example – are considered to be beneficiaries of government employment and so excluded and considered to be less deserving than, say, Cheshire and Gloucestershire which include some very successful areas even in these difficult times.
4. Geographical eligibility will depend on where the principal place of business is. Where there is more than one such place, you look at where the greater part of the business is carried on. If not in an excluded region then all employees – including those working wholly in an excluded region – potentially qualify. But this seemingly generous treatment works to disadvantage in reverse.
5. Businesses that commenced on and after 22 June 2010 can take a NIC holiday for up to 12 months' contributions from 6 September 2010, in respect of the first 10 employees taken on in the first year, beginning from the actual day that trading commenced.
6. In the case of companies, directors count towards the maximum of 10.
7. Only trading, professional, vocational, etc organisations (including charities carrying on a trade) qualify. So, for example, householders taking on domestic staff for the first time will not qualify. And public bodies will not qualify.
8. The holiday is to be administered as 'de minimis' State Aid and so some businesses will have their entitlement reduced. The coal industry is completely excluded. And there will be a reduction on the NIC holiday relief available where a business has already received some other form of EC de minimis State Aid – this would be difficult to achieve (though not impossible), however, since only new businesses can qualify in the first place. There are financial limits for the agriculture, fisheries, aquaculture and road transport sectors.
9. In addition, managed service companies cannot benefit – nor can IR35 companies as regards 'deemed payments'. Any regular salary paid month by month by an IR35 company would however be eligible for relief.
10. If an employee leaves, his or her replacement does not qualify if 10 employees are already in place. If the employee is re-employed (whether or not the full 10 employees are in place by then) the holiday for that employee continues up to the original end-date or until the £5,000 maximum relief is obtained for that employee.
11. Where – perhaps unusually for a new business – NICs are due at the contracted-out rate, the NIC holiday entitlement is to a reduction of the full, not contracted-out contributions that would have been due on the same earnings.
12. The relief applies only to Class 1 contributions – not to Class 1A nor Class 1B.
13. New businesses in the EU can potentially qualify where they send workers to the UK (and outside the excluded areas) in circumstances where liability to UK contributions exists.
14. Relief is not compulsory and businesses will need to apply.
15. In addition, records of the employees concerned, their earnings and contributions – among other details – will need to be retained.
16. There will be a separate NIC holiday end-of-year return as at each 5 April. This should enable HMRC to avoid picking up the NIC holiday relief obtained as what would otherwise appear to be an underpayment on the P35.

ICAEW TAX FACULTY, 31 August 2010

Update on employment related securities

In the past year or two, a succession of cases has had a bearing on this legislation, even if indirectly. In this article Ken Moody has drawn together certain threads from these decisions into a review of the current state of play.

References are to ITEPA 2003 unless otherwise stated.

Gray's Timber

Very briefly, under Part 7, Chapter 3D, if shares are disposed of for more than their market value, the excess counts as employment income. The crucial issue in *Gray's Timber* was whether its managing director (Mr Gibson) had received more than market value for his shares in Gray's Group Ltd (the parent) on the sale of that company (under an agreement giving him a right to a greater than *pro rata* share of the sale proceeds).

The particular circumstances in *Grays Timber* seem exactly what Chapter 3D was designed for. The relevant parts of the judgments given at the Supreme Court were adopted as guidance in the UBS case and the decision is therefore an important strand to this review.

Market value and Part 7

What is meant by 'market value' in Part 7 should be straightforward in one respect, because s 421 imports the capital gains tax definition from TCGA 1992, s 272. The stated intention was for the same meaning to apply consistently throughout Part 7, as can be seen from the following frequently asked questions (FAQs) which were released at the time of the Finance Bill 2003:

> 'Q1(k): Market value is now based on the CGT definition. Does this mean that personal restrictions on the share no longer have to be taken into account in arriving at its value?
>
> 'A: No. Even where there is, for example, a restriction on sale the shares must be valued as if that restriction would still apply to their hypothetical purchaser. It is the asset (as it is) that is being valued, not some other unrestricted asset.'
>
> 'Q1(m): The Inland Revenue has confirmed that "market value" will take into account personal rights and restrictions and not just those rights and restrictions attaching to the shares. Can you confirm that this interpretation of "market value" will be applied consistently throughout Schedule 22 [to the Finance Act 2003] and that you will not adopt a different interpretation for each chapter of Part 7?
>
> 'A: Market value will be determined on a consistent basis throughout Chapters 1 to 5 of Part 7.'

At the Supreme Court in *Gray's Timber*, Lord Walker was particularly critical of the above FAQs, especially as counsel for HMRC had argued precisely the opposite, i.e. that in valuing Mr Gibson's shares, rights, which were personal to him and of no value to the purchaser (even had they been capable of transfer), should be ignored.

Lord Walker went on to consider the meaning of 'market value' in other chapters of Part 7:

> 'I come to the other strand [of counsel for the company's argument], which relies on the use of the expression "market value" in chapters of Part 7 other than Ch 3D, that is Ch 2 (restricted securities), Ch 3 (convertible securities), Ch 3A (securities with artificially depressed market value) and Ch 3B (securities with artificially enhanced market value). All these chapters describe the relevant restriction, conversion right or value-shifting mechanism in the most general terms, which would include 'extrinsic' arrangements: see s 423(1)(a), s 436, s 446A(2) and s 446K(2). *But they also proceed on the footing that that restriction, conversion right or value-shifting mechanism affects the market value of the securities in question: see s 428(2), s 431(1), s 441(6) and (7), s 442(5), s 446C(2), s 446D(1), s 446E(3), s 446F(4), s 446G(1) and (2), s 446H(3), s 446I(3) and s 446L(6). In all these contexts the restriction, conversion right or value-shifting mechanism cannot, it seems to me, be dismissed as something collateral or personal to the particular employee and irrelevant to the valuation* [emphasis added].
>
> 'It is a very puzzling feature of the legislation, and the confusion is increased by the official answers to "frequently asked questions" published by HMRC's predecessor in 2003 (and made available to taxpayers and their advisers until 2005).'

As an example of this 'puzzling feature' for the purposes of Chapter 2, s 423(1) defines securities as restricted if 'there is any contract, agreement, arrangement or condition, which makes provision to which any of subsections (2) to (4) applies, and the market value of the employment-related securities is less than it would be but for that provision'.

An open market valuation would normally exclude extrinsic or personal restrictions, but according to Lord Walker such restrictions cannot be dismissed as irrelevant to the valuation and, indeed, if that were the case, Chapter 2 would be in serious trouble.

However, the 'market value' which s 423(1)(b) is talking about is not the same 'market value' which applies for the purposes of Chapter 3D, despite the definition in s 421. So much for consistency.

Having regard to Lord Walker's remarks, the situation as it stands seems to be that, for the purposes of s 423(1)(b), one must have regard to all restrictions, whether personal, collateral or within the company's articles. We then need to value the shares ignoring all restrictions.

The legislation refers to these values as actual market value (AMV) and unrestricted market value (UMV). Clearly if AMV is less than UMV the shares are restricted.

Actual market value is described by David Bowes as 'fictional' in his article 'The Wonderland of share valuation', *Tax Adviser*, August 2009, and, as can be seen, neither value necessarily represents open-market value. However, David's article reports that some modus operandi has been reached with Shares & Assets Valuation and so Lord Walker's comments may reflect what actually happens 'on the ground', since without some such accommodation the legislation may be unworkable.

There is a further piece to this puzzle. Any amount taxable on acquisition would be earnings within s 62, based on the value of the securities in 'money's worth'. HMRC's *Shares and Assets Valuation Manual* SVM 109030 states that 'Experience has shown that the number of cases where "money's worth" differs from "open market value" is small'.

What appears to be meant by this is not the statutory open-market value (which would ignore personal restrictions), but AMV. One way or another it seems we cannot avoid acquaintance with these fictional characters, but at least there seems to be some rational way forward which was previously unclear.

UBS AG

UBS is the only case so far which, apart from *Gray's Timber*, directly concerns Part 7. It involved a scheme to avoid PAYE/National Insurance by awarding shares instead of bonuses.

Employees of UBS were offered redeemable shares in an independent special purpose vehicle (SPV), the articles of association of which provided that the shares would be forfeited for 90% of their market value if the FTSE 100 share index exceeded a certain figure during the 'restriction period'.

The SPV also entered into hedging arrangements involving options, the result of which was that, in the event that the forfeiture provision took effect, the employees' exposure was limited to 0.8% of the amount of the bonus they would otherwise have got.

The scheme was designed so that the shares would be restricted securities within s 423. Under s 425, no tax charge arises on acquisition of forfeitable securities if the forfeiture provision expires within five years.

However, if an event occurs which affects all the shares of the class (in this instance either on expiry of the restriction period or on forfeiture), no chargeable event arises in some circumstances (s 429).

Thus no charge would have arisen either on acquisition or on expiry of the restriction period if the scheme had worked. HMRC issued PAYE determinations under Income Tax (Pay As You Earn) Regulations 2003, regulation 80 and decisions under Social Security Contributions (Transfer of Functions, etc) Act 1999, s 8.

The First-tier Tribunal concluded that any reduction in the market value of the shares as a result of the arrangements was insignificant as there was only a very small chance that the employees would receive less than full value. The shares were therefore not restricted and were taxable on acquisition as earnings within s 62.

A similar scheme would now be ineffective due to changes introduced by F(No 2)A 2005 where tax avoidance is involved.

The general perception is that the test under s 423(1)(b) of whether the market value of securities is reduced as a result of a restriction is absolute rather than relative.

If, as argued by counsel for HMRC, an insignificant reduction may not bring down the weight of Chapter 2, then perhaps a wider variety of securities may escape being regarded as restricted and it is certainly better to be 'out' rather than 'in'.

PA Holdings

PA Holdings concerned a scheme to reward employees by payment of dividends on shares in an SPV owned by a Jersey Trust. The scheme was intended to avoid PAYE/National Insurance on £6.7 million of discretionary bonuses.

The Upper Tribunal essentially upheld the First-tier Tribunal's decision. There was no question but that the dividends were earnings 'from' the employment under the test proposed in *Hochstrasser v Mayes* 38 TC 673.

Now under s 716A, where income falls within Parts 2, 9 or 10 of ITEPA but also within ITTOIA 2005, Part 4 Chapter 3 'Dividends from UK resident companies etc', priority is given to taxation as dividends, so 'Schedule F' still trumps 'Schedule E'.

However, Part 7 Chapter 4 'Charge on other chargeable benefits from securities' may apply to any 'benefit' received in connection with employment-related securities.

Section 447(4) excludes benefits otherwise chargeable to tax from the application of Chapter 4 unless 'something has been done which affects the employment-related securities as part of a scheme or arrangement the main purpose… of which is the avoidance of tax or National Insurance contributions'.

Be that as it may, the structure of ITEPA is that although Part 7 quantifies the amounts which are to count as (specific) employment income, the charge to tax is under Part 2, as is clear from the wording of s 3, s 6, s 7, s 9 and s 10.

It would follow that dividends may fall within Chapter 4, if the proviso to s 447(4) applies, but only as a stand-alone charge and irrespective of s 716A: a double 'hit', in other words.

While HMRC guidance does envisage this possibility (see *Employment Related Securities Manual* ERSM 90210), one of the unwritten rules of income tax is that income can be taxed once only: if a receipt falls within more than one charging provision, in the absence of clear authority to impose a double charge it must be decided as a matter of law which charge should prevail.

If taxation of dividends under Chapter 4 hangs upon the proviso to s 447(4), that hardly counts as 'clear authority' (which may be why Andrew Thornhill QC reportedly described that amendment as a 'damp squib'). Indeed, HMRC's preferred course of action is to treat the dividends as earnings within s 62 in the examples given at ERSM 90210.

However, in some ways PAYE is a distraction. Many of the more provocative arrangements would disappear if National Insurance were payable irrespective of any PAYE liability and therefore *PA Holdings* may yet prove something of a holy grail for HMRC.

That should not affect the mainstream of private company owner-managers who choose to draw dividends instead of remuneration, since the issue of derivation arises, i.e. profits, earnings or a mixture of both.

In any case, if a director has no contract of employment, he is not entitled to remuneration and in those circumstances, arguably, the dividends cannot represent earnings.

Uniplex

The recent case of *Uniplex (UK) Ltd* purported to involve an alphabet-type share structure, but the shares were never issued. The implementation of the arrangements was highly irregular and the case seems to have been doomed to failure.

The scheme involved employees agreeing to work for only the national minimum wage, topped up by payments from an SPV via a discretionary trust – which was not set up. The documentation was faulty and no copy of a brochure describing the 'profit share agreement' could be produced in evidence.

The employees were paid exactly the same amounts in total as they would otherwise have received in remuneration and bonuses, so the question must therefore arise whether the arrangement was a sham anyway.

Each employee was to have been allotted a share of a single class from A to L but, due to difficulties in opening a bank account for the SPV, only one share was issued which it was intended would be subdivided between the scheme members at a later date: however, a document purporting to do so was shown to be false.

The First-tier Tribunal dismissed the company's appeal. There was no doubt that the receipts arose 'from' the employment, using the test in *Hochstrasser v Mayes* and as applied in *PA Holdings*.

Taken from an article by Ken Moody

Taxation 24 November 2010

Lecture B628 (12.18 Minutes)

Company cars - advisory fuel rates from 1 December 2010

These rates apply to all journeys on or after 1 December 2010 until further notice, allowing them to reflect fuel prices more quickly. For one month from the date of change, employers may use either the previous or new current rates, as they choose. Employers may therefore make or require supplementary payments if they so wish, but are under no obligation to do either.

Engine size	Petrol	Diesel	LPG
1400cc or less	13p	12p	9p
1401cc to 2000cc	15p	12p	10p
Over 2000cc	21p	15p	15p

Petrol hybrid cars are treated as petrol cars for this purpose.

These rates are calculated from the fuel prices in the tables below:

Petrol

Engine size (cc)	Mean MPG	Applied MPG	Fuel price (per litre)	Fuel price (per gallon)	Pence per mile	AFR
up to 1400	47.4	42.6	119.0	540.9	12.7	13
1400 - 2000	40.2	36.2	119.0	540.9	14.9	15
over 2000	28.2	25.4	119.0	540.9	21.3	21

Diesel

Engine size (cc)	Mean MPG	Applied MPG	Fuel price (per litre)	Fuel price (per gallon)	Pence per mile	AFR
up to 2000	53.9	48.5	122.7	558.0	11.5	12
Over 2000	41.5	37.3	122.7	558.0	15.0	15

LPG

Engine size (cc)	Mean MPG	Applied MPG	Fuel price (per litre)	Fuel price (per gallon)	Pence per mile	AFR
up to 1400	37.9	34.1	66.4	301.9	8.9	9
1400 - 2000	32.2	29.0	66.4	301.9	10.4	10
over 2000	22.6	20.3	66.4	301.9	14.9	15

Notes:

1. Mean mpg - miles per gallon - from manufacturers' information, weighted by annual sales to businesses (Fleet Audits, 2009).

2. Applied mpg - adjusted downwards by 10 per cent to take account of real driving conditions and lower fuel economy for older cars.

3. For LPG, mpg is assumed to be 20 per cent lower than for petrol due to lower volumetric energy density.

4. Department for Business, Innovation & Skill's latest petrol and diesel prices (22 November 2010), LPG (UK Average) from AA website (November 2010).

Will the rate per mile figures change if fuel prices go up or down?

The rates are reviewed twice a year. Any changes will take effect on 1 June and 1 December and will be published on the HM Revenue & Customs (HMRC) website shortly before the date of change.

HMRC will also consider changing the rates if fuel prices fluctuate by 5 per cent from the published rates when each review is made and we consider the price change will be sustained.

Employers should make themselves aware of any changes by referring to this page in late May and November each year. It is the primary source of information.

VAT

Customs will also accept the figures in the table for VAT purposes though employers will need to retain receipts in line with current legislation.

Capital Taxes

I Iny

In 1994, the taxpayer, a property developer and entrepreneur, sold the entire shareholding in Castlegold Properties Ltd to Harlequin, a company controlled by his family via an offshore trust.

HMRC said the gain was not at arm's length and TCGA 1992, s 17 came into play.

After reviewing the facts, the First-tier Tribunal decided that the price obtained for the shares, i.e. £20,000, was 'no more than a token payment bearing no necessary relation to the underlying value of the asset sold'.

The sale was not therefore made at arm's length and should be treated as having been made at market value.

The tax should be assessed on the market value of the holding which, in light of the evidence provided, the tribunal put at £2,129,526.

The taxpayer's appeal was dismissed.

Dividend is trust capital

Following a share reorganisation, the trustees of the Raymond Taube 1991 Discretionary Settlement received a special dividend of £240,000.

At the behest of their advisers, the trustees treated the dividend as trust capital rather than as being available for distribution. HMRC opened an enquiry into the settlement, amended the relevant tax returns and issued assessments on the basis that the dividend was income.

The taxpayer appealed.

The First-tier Tribunal noted that, generally, company profits distributed as dividends to trustees are considered trust income. In this instance, there was nothing in the trust deed that said a special dividend should be capital.

Therefore monies paid by way of the special dividend to the trustees would be trust income.

The appellant argued that the special dividend was exceptional in terms of amount and reduced the value of the shares as an investment, thus justifying the conclusion that the dividend was capital.

The tribunal did not accept this argument but said that the special dividend was a cash dividend, as it did not have the features of a capitalisation. The dividend would be taxable at the Schedule F special rate of 25% subject to the tax credit.

The appeals in respect of the Raymond Taube Settlement and Mr Taube were dismissed.

However, a similar appeal in respect of the Bessie Taube Discretionary Settlement was allowed because no tax would arise, regardless of the outcome.

Even if the special dividend received by the trustees of this settlement were treated as income, that income would be taxable under TA 1988, s 1A at the Schedule F ordinary rate of 10%. That liability would then be completely franked or offset by the tax credit attached to the dividend.

Trustees of the Bessie Taube Discretionary Settlement Trust; Trustees of the Raymond Taube Discretionary Settlement Trust; Raymond Taube (TC735)

Administration

Tax policy - the bigger picture

Groundhog Day?

Movie fans might remember the 1993 comedy 'Groundhog Day', where actor Bill Murray found himself repeating the same day over and over again. 2010 has felt like the tax version of the movie, except that every few months we've repeated the Budget/Finance Bill experience of seeing more legislation announced and then enacted. The **first Finance Bill of 2010** was the last gasp of the previous Government. It included the legislation for the bank payroll tax, the Stamp Duty Land Tax (SDLT) 'holiday' for first time buyers up to properties of £250,000 and more stringent rules on disclosure of tax avoidance schemes.

The second Bill, which led to the **Finance (No.2) Act 2010** was pleasing short – just 11 clauses and 5 Schedules (see http://www.opsi.gov.uk/acts/acts2010/ukpga_20100031_en_1). It followed the 22 June 2010 Emergency Budget and received Royal Assent on 27 July. It confirmed that the main rate of corporation tax will fall by 1% to 27% from next April, that the top rate of capital gains tax (CGT) has increased to 28% from 22 June and that the standard VAT rate will go up on 4 January 2011to 20%.

The Act also repealed the proposed high income excess relief charge due to start next April.

But there is more. A **third Finance Bill** came out on 30 September, was withdrawn and then reissued on 1 October 2010. It contains a number of items around carers, something on seafarers' deductions and other minor changes. This is not as significant as the range of measures we'll see up to Christmas including an autumn statement rather than a full blown Pre Budget Report. These announcements may include a variety of items including provisions relating to eight consultation documents setting out proposals for new rules and reforms ranging from PAYE to pensions tax, bringing inheritance tax into the disclosure of tax avoidance scheme rules, furnished holiday lettings rules, controlled foreign company changes and travel and subsistence payments under the national minimum wage. Change is undoubtedly very much on the coalition Government agenda but we are getting advance notice. We already know next year's Budget will be on 23 March 2011.

Office of Tax Simplification

Given the rush of new tax legislation you may wonder how in almost the same breath the Government can launch an Office of Tax Simplification (OTS). However, this is a really interesting new initiative that sees the UK take its first steps towards trying to tackle the proliferation of complex tax rules.

The Rt Hon Michael Jack and well respected tax adviser, John Whiting, have been appointed to lead the Office on an interim basis. The official remit of the OTS is:

'To provide independent advice to the Chancellor on simplifying the UK tax system, with the objective of reducing compliance burdens on both businesses and individual taxpayers … The Office will publish individual reports on its inquiries that set out evidence it has collected, including on the views of interested parties, its analysis of potential options, and proposals for simplification.' (See framework document linked to http://www.hm-treasury.gov.uk/ots.htm.)

Hardly starting with something straight forward the first two big tasks for the OTS are to:

1) **review a list of all reliefs**, allowances and exemptions within the taxes and duties administered by HMRC and identify those reliefs that should be repealed or simplified to support the Government's objective for a simpler tax system. A report is now out with a view to possible legislation in the Finance Bill 2011.

2) **suggest ways to simplify small business taxation** including IR35 and recommend priorities. This will result in a report around Budget 2011.

These are very worthwhile tasks. I (and many others) have lobbied for an improvement on IR35 for a decade and I suspect you all have good suggestions to help improve the taxation of small businesses. However, we also know how hard these items can be. They have languished on the 'too difficult pile'

for that very reason and the big test for the OTS will be to see if the Government is willing to back what may prove to be tough recommendations.

Equally any changes always give rise to winners and losers. Will people be so supportive of simplification if it puts them at a tax disadvantage? These are all battles to come, but I think the OTS is a very positive step and hopefully will receive support from the tax profession.

Tax Professionals Forum

Another new initiative is the Tax Professionals Forum. The official remit here is 'to support the Exchequer Secretary, HM Treasury and HMRC in identifying improvements to the way in which we make tax policy. This will include:

- the way in which policy is developed;
- the way in which policy and changes in policy are communicated; and
- the way in which policy is legislated and implemented.'

The Forum is intended to help prioritise improvements and monitor implementation of these improvements to ensure they have the intended effect. The Forum also has a role in providing real-time feedback on whether the Government's stated principles and this new approach to tax policy making are being followed in practice: challenging the Government where this is not the case.

The official minutes can be found on the HM Treasury website.

Some of the initial issues being discussed include emerging themes around tax policy. These included:

- the merits of having an overarching framework for tax policy, which provides a clear direction of travel;
- the importance of simplification, and slowing down the volume and frequency of changes to the tax code;
- the importance of having tax legislation that was properly scrutinised and tested, against the background of a clear policy objective;
- the value of meaningful and early consultation; and
- the challenge of keeping track of development in tax policy and legislation, and the benefits of greater predictability as to the timing of announcements/changes.

Contributed by Francesca Lagerberg

Lecture P630 (9.11 Minutes)

Penalties for late CIS returns

Penalties for late CIS contractor monthly returns will change from October 2011.

In many cases, the new penalties will be less than what would be charged now. In particular, for new CIS contractors, there will be an upper limit to some of the penalties that are charged. This upper limit will apply when new contractors first send a monthly return, if that return and any other monthly returns that are sent at the same time, are late.

Although the new penalties do not start until October 2011, HMRC has published guidance explaining how the rules may apply early at the taxpayer's request. Any contractor who has been, or is, charged penalties for filing a monthly return late before October 2011, may ask HMRC to:

- work out how much the penalties would be under the new rules, and, if less than the amount already charged
- agree that their penalties should be reduced to the lesser amount

Current rules

Late submission of the contractor monthly return will currently incur a penalty of £100 for each of up to 12 consecutive months that the return is not submitted by its due date or by the 19th of each consecutive month, s 98A TMA 1970.

After 12 monthly penalties have been charged, if the return is still outstanding, a final penalty in the range of £300 to £3,000 is charged depending on how many other final penalties had been charged over the previous twelve-month period.

When the returns are eventually received, the initial penalties of £100 will be increased where the returns show entries for more than 50 subcontractors.

New rules from October 2011

The new penalty system under Sch 55 FA 2009 starts in October 2011. The first return to attract a penalty under Sch 55 will be the return due for the month ended 5 November 2011.

Penalties will be charged as follows.

- Initial failure to meet due date of the 19th of the month - a penalty of £100 will be charged.
- Return still outstanding two months after due date - a further penalty of £200 will be charged.
- Return still outstanding six months after due date - a 'tax-geared' penalty becomes due. This penalty is the greater of 5% of any deductions shown on the outstanding return, or £300.
- Return still outstanding twelve months after due date - a second 'tax geared' penalty becomes due.

Contractors new to CIS

Under the new rules, if you have not sent any previous returns and are filing your first returns late, there will be an upper limit of £3,000 on the total fixed penalties (£100 and £200) that may accrue.

This upper limit does not apply to any 'tax-geared' penalty except that, where it applies, it removes the £300 minimum penalty that would otherwise be charged where the tax-geared penalty is less than £300.

Evidence before the Tribunal

The recent decision of the First-tier Tribunal in *MJP Media Services Limited* highlighted how taking a case to the independent tax tribunals often raises difficult evidential issues which require careful navigation.

The decision

MJP was a wholly-owned subsidiary of Carat International (Carat), which in turn was a wholly-owned subsidiary of Aegis plc (Aegis). Between 2001 and 2004, a series of intercompany transactions took place between MJP and Aegis. As a result of these, as at 1 January 2004, Aegis owed MJP £6,815,366.

Between 1 January and 26 March 2004 (the precise date being unknown), a document was signed between these two companies 'made effective from 1 January 2004', stating that these monies had been loaned by MJP to Aegis. Interest was to be charged at base rate plus 1%.

On 26 March 2004, the same two companies signed a document entitled 'deed of waiver' (the waiver), under which MJP waived the sum of £6,704,000 leaving an outstanding amount (after adding accrued interest) of £189,976. The waived amount was duly claimed as a deduction by MJP.

The issues

1. Was the intercompany debt 'a transaction for the lending of money' and therefore within the definition of a loan relationship contained in FA 1996, s 81 (see now CTA 2009, s 302 and s 303)? (The evidence issue)
2. If a loan relationship did exist, did MJP's waiver of part of that loan allow it to claim a deduction in its tax computations for the waived amount?

A lending of money

The first issue was whether the intercompany debt was a transaction for the lending of money?

MJP's primary argument was that Aegis's debt to it consisted of a series of cash payments: they were thus clearly 'for the lending of money'. HMRC did not accept that this was the case and put MJP to strict proof that the transactions were of money or cash and thereby amounted to the lending of money.

After careful consideration of the evidence relied upon by MJP, the tribunal concluded that MJP had failed to prove, on the balance of probabilities, that it had made payments to Aegis. The judges held that MJP made payments to third-party creditors of Aegis and that these sums were recorded in the group's accounts as amounts owing by Aegis to MJP.

This being the case, they concluded that the transactions were not 'transactions for the lending of money'.

In their view, payments to a third party to discharge the debts of another do not give rise to a loan relationship. The judges accepted that there is no need for cash to change hands in order for there to be a transaction for the lending of money.

However, in such cases, a taxpayer must produce sufficient evidence of such a transaction. Their view was that MJP had failed to provide sufficient evidence to establish its case and the judges made the following comments:

> 'It would have been a simple matter for MJP to prove that payments were in cash: it only had to produce the relevant bank statements.
>
> 'It is hard to understand why this basic documentation was not available to explain the transactions. The tribunal was instead faced with a patchwork of accounting entries and partial documentation.
>
> 'The lack of bank statements, the absence of any witnesses with personal knowledge of the transactions, and the piecemeal documentation (however assembled) are all significant factors. It is for the appellant to prove its case, and we find that, on the balance of probabilities, MJP also failed to discharge this burden…'

Lessons to be learnt

The forthright comments made by the tribunal, in relation to the insufficiency of the evidence placed before it, reflect the importance of documentary and witness evidence in appeals where relevant facts are disputed by HMRC.

Pre-litigation, where a transaction is likely to be challenged by HMRC, taxpayers would be well advised to proceed on the basis that any relevant documentation will in due course have to be provided to HMRC and is likely to be closely examined.

This will focus the minds of those engaged in the transaction and encourage such persons to think ahead and ensure that all relevant documentation is retained and available for production. It is difficult to prepare an effective case many years after the event if relevant documentation and/or key witnesses of fact are no longer readily available.

The time to ensure that all relevant documentation (including electronically stored documentation) is in order and available for future reference is when the transaction in question is being implemented.

With reference to the litigation itself, it is self-evident that sufficient evidence needs to be placed before the tribunal if an appellant taxpayer is to discharge the burden of proof placed on him.

In practice, the tribunal will expect to hear oral evidence to support the documentary evidence and to provide further evidence not dealt with in the documentary evidence. The tribunal will expect an appellant to call witness evidence that is both credible and relevant to the facts in dispute.

Cases are often won or lost on their facts, and in cases which turn on their facts, an appellant who fails to present sufficient evidence in support of its case, is bound to fail.

From an article contributed by Adam Craggs writing in Taxation

Clients' returns 'may not be correct for a number of reasons'

A firm of accountants specialising in clients within the TV industry is the subject of a rare criminal investigation by the taxman.

The department has written to the clients of Christopher Lunn & Company of Crowborough, East Sussex, stating that, from information obtained so far, 'tax returns submitted to HMRC may not be correct for a number of reasons'.

Clients have been given until 30 November to make a full disclosure, after which irregularities discovered 'will be dealt with either by criminal or civil procedures… depending on the nature of those irregularities.'

A spokesperson from Bell Pottinger, which is handling media enquiries for the accountancy firm, said the owners and staff first became aware of the investigation on 22 June, when representatives of HMRC paid a visit unannounced.

Since then, Christopher Lunn & Co. has been co-operating with the taxman's investigation and is sure of being exonerated in the fullness of time, but the firm has yet to be informed of any specific allegations against it.

The investigation is ongoing. The accountancy firm is aware clients have been contacted by post but does not know whether that means all clients or only some.

Asked whether any practices in dealing with clients could have triggered the investigation, a spokesperson said Christopher Lunn & Co. had been in business for 40 years and had more than 7,000 clients; it had never before had issues with the Revenue that could lead to concern about its practices.

The firm is not a member of any professional body. The owner, Christopher Lunn, is a former member of the ICAEW, having resigned from the organisation. Some staff members hold accountancy or tax qualifications at various levels. The firm does have professional indemnity cover, the spokesperson said.

Clients are not insured with a third party insurer against investigations. Instead, the firm operates an enquiry fund into which clients pay an optional premium to be covered against the cost of investigations. The fund will not be used to cover the investigation into Christopher Lunn & Co. (which is being legally represented by McGrigors solicitors), but it could be called on to cover the cost of enquiries into clients which result from the main investigation.

The fund will only pay for work carried out by Christopher Lunn & Co. Unusually for a business of its size, it has a separate team of five employees who appear to handle only HMRC investigations into the firm's clients. They are pictured on the firm's website in combat fatigues and body armour, carrying paintball guns: a joke that was seen as unwise by some advisers to whom *Taxation* spoke.

The areas of concern listed by the Revenue in their letter to clients dated 17 September fall into two broad categories. The first was a list of areas in which excessive claims for expenditure may have been made, and it included headings most advisers will recognise, such as travel and subsistence, and use of home as office.

On the latter, Christopher Lunn & Co. had informed clients that they used a figure of 'up to' £520 a year. HMRC more recently said that, while they will accept a figure of up to about £3 per week as an estimate, claims for more than this should be based on a proper calculation of the expenses (rent/mortgage interest, heat and light, etc) apportioned for time and area.

Christopher Lunn & Co. optimistically suggested this may mean clients could claim more than was included in their accounts and get a repayment. In practice it is rare, though not unknown, for investigations to end with repayments, and only those whose full-time work is carried out mainly in their home can normally claim significant amounts as expenses.

The Revenue's letter also listed accountancy fees as an area of concern, and Christopher Lunn & Co. acknowledged in a letter to clients on their website that this may have been over-claimed. The firm says it includes a standard provision in the accounts, and that if less help was required on bookkeeping this may have overstated the expense.

While an over-provision might be made by an accountant in one year's figures, this would normally be corrected automatically in the following year.

Taxation approached investigation specialists and asked how they would advise clients who received letters such as the ones sent to Christopher Lunn & Co.'s clients. Their comments should not be taken as professional advice, since that could only be given on a personal basis in full knowledge of the facts, nor should they be taken as accepting the truth of the allegations made by HMRC.

John Cassidy, a tax investigations partner at the London office of accountants PKF, did not think the criminal investigation was likely to have been triggered by over-claims such as the ones detailed above, which would normally have been dealt with by investigations into clients' returns.

He believed it was more likely to have resulted from HMRC's belief that clients were 'routinely, and apparently falsely, claiming self-employment status by directors', which was part of the second set of areas listed in the taxman's letter. This included allegations of retrospective creation or apportionment of income and expenses into a limited company.

According to its website, Christopher Lunn & Co. will typically advise clients to have a self-employed trade running alongside a limited company when they are 'not just performing the duties of a company director but also carrying out some or all of the tasks for which the company gains its revenue', and that work is of a creative nature.

John Cassidy and another investigations specialist consulted by Taxation felt this arrangement could sometimes be justified but was disliked by the Revenue, and that it was particularly hard to justify if the only receipts in the self-employed trade came from the client's own company.

Mr Cassidy was concerned that a checklist made available to clients on the firm's website, showing what to bring to an accounts preparation meeting, said that for income and expenditure, 'we would like to see totals. The meeting will certainly not work if we need to go through your receipts for time you have booked.'

This could lead to clients thinking the accounts were fine because they had been prepared by an accountant, when insufficient work had been done for tax purposes, said Mr Cassidy, adding that there should at least have been a discussion advising the clients that they must have absolute faith in the totals they provided.

Asked what clients of the firm who have received a letter should do now, John Whiting, tax policy director at the Chartered Institute of Taxation, said, 'If people get this sort of letter from HMRC then they need to get professional advice and support – and they need to decide whether their existing adviser is in the best position to help.

'That may well point them towards getting a second opinion, although they will no doubt be influenced by what their current adviser is saying. But, above all, they need to take this sort of letter seriously.'

Both John Cassidy and other investigations specialists agreed that taxman's written offer to clients of Christopher Lunn & Co. was positive given that it appears there will be little or no penalty to pay in addition to the tax and interest the Revenue will inevitably collect, provided an offer to come forward prior to 30 November is taken up.

If HMRC use their full civil powers in cases in which the taxpayer has not co-operated, penalties can be up to 100% of the unpaid tax. Christopher Lunn & Co. has advised its clients to give all possible assistance to the department, although it remains unaware of any way clients can do so, since the firm has not been told of the specific allegations against it.

Clients should therefore double-check their records, accounts and tax return, said John Cassidy. If errors on Christopher Lunn & Co.'s part were shown to have taken place, there might be a claim against the firm for professional negligence, so it might be appropriate to carry out the checks for free.

'I would have thought that the client will get more comfort from a third party doing this work and HMRC will pay more attention to that third party's findings,' remarked Mr Cassidy.

Taxation, November 2010

Discovery strategy

If HMRC do not issue a notice of enquiry within the normal deadline of 12 months after the filing due date, you and the client will want to be certain that there is no possibility of HMRC being able to enquire into that year's tax position (unless of course the client has deliberately concealed income).

There is now more guidance on this issue from case law, but as far as the legislation is concerned it states that discovery assessments can be made in the following circumstances where HMRC can show that there has not been full disclosure:

- The loss of tax is brought about carelessly or deliberately by the taxpayer or agent; or
- The HMRC officer could not have been reasonably expected to have identified the circumstances giving rise to the loss of tax before (a) the end of the normal enquiry deadline, or (b) before the conclusion of any enquiry, on the basis of the information that had so far been made available to him.

It has long been thought that this loads the dice very much in favour of HMRC, especially when looking at the definition of information being made available to an officer as under:

a) it is contained in the taxpayer's return or claim for the year, or in any accounts, statements or documents accompanying the return or claim

b) it is contained in any documents, accounts or particulars which, for the purposes of any enquiries into the return or any such claim by an HMRC officer, are produced or furnished by the taxpayer to the officer; or

c) it is information the existence of which, and the relevance of which as regards a loss of tax, could reasonably be expected to be inferred from information falling within the above or notified in writing by the taxpayer.

Langham v Veltema Court of Appeal (2004) EWCA Civ 193

Tax advisers generally adopt the policy of disclosing arguably more than is necessary, so as to obtain protection for the client. HMRC's view is that adding supplementary information and papers to the tax return (including the business accounts) is not in itself necessarily full disclosure; they must be clearly told exactly what the material is disclosing. This has led to the generally held belief that there can be no certainty and that HMRC have matters very much their own way.

The taxpayer in this case, Mr Veltema, was liable to income tax on the value of a house transferred to him by his employer on retirement, and was advised that the value of £100,000 should be included in his tax return for the year ended 5 April 1998. The Inspector advised on 9 September 1998 that the return had been processed without the need for any correction. Later on, beyond the enquiry deadline for that return of 31 January 2000, the Inspector dealing with the company's tax affairs decided that the true value was more than £100,000. After negotiation it was agreed that the value was £145,000 instead. The consequential assessment to income tax on £45,000 was rejected by the General Commissioners on the grounds that the Inspector had no power to make a discovery assessment under Section 29 TMA1970. The Inspector's appeal to the High Court was on the grounds that on the basis of the information available before the normal enquiry deadline, he could not have been reasonably expected to be aware that an assessment to income tax based on a value of £100,000 was insufficient.

The High Court decided that Section 29(5), in using the words *on the basis of* did not limit the sources of information which the Inspector was assumed to have to simply what was in the tax return and accompanying documents. To put it another way, he cannot exclude anything else which he could reasonably be expected to have known or found out and which was readily available to him.

Unfortunately, but hardly surprisingly given the exact wording of the legislation, this wide (but arguably sensible) interpretation was rejected by the Court of Appeal and leave to appeal to the House of Lords was refused.

Obtaining certainty on behalf of your client is now very difficult as an assessment has to be made of exactly what should be disclosed to avoid a discovery being made in the future. Where the matter involves the valuation of an asset, use of the post-transaction valuation check procedure via form CG34 can only be recommended except in special circumstances. If this is not the matter of concern,

full disclosure must be made in such detail that the result may well be the opening of an enquiry within the normal window.

HMRC's guidance

This is found in Statement of Practice SP 1/06 – SELF ASSESSMENT: FINALITY AND DISCOVERY to include corporation tax.

On valuation issues it does provide some positive light as it says that if the following can justifiably be stated in the Additional Information space at the end of the tax return, the client will be able "for all practical purposes" to rely on protection from a later discovery:

- a valuation has been used
- the name of the person who made the valuation
- confirmation that he or she was a named independent and suitably qualified valuer (if that was the case) who carried out the valuation on the appropriate basis

The above protection is not available where the same transaction is the subject of an agreed valuation in a later related tax return. An example of this would be a property owned by a company and transferred to a director, where this is the subject of a subsequently agreed valuation in the company tax return. Also vulnerable to a discovery would be the sale of a company where the shareholders dispose of their shares and each tax return is then regarded as related.

The capital gains supplementary pages no longer ask for specific details of the purchaser of the asset disposed of etc., in terms of any connection with the vendor, but not making any mention will clearly expose your client to a potential discovery.

On other judgmental issues the guidance is hardly positive, although it is said that it may be possible to gain finality with the more exceptional items of expenditure such as repairs. It gives the example of making an entry in the Additional Information space pointing out that a programme of work has been carried out that included repairs, improvements and new building work, with the total cost having been allocated to revenue and capital on a particular basis (which is then explained).

The other area of potential dispute is where in a tax return a different view of the law has been taken from that published as HMRC's view. The suggestion from them is to make that clear in the Additional Information space, thereby offering them the opportunity to issue an enquiry notice. If that opportunity is not taken, no discovery can be made – and this is the case even if further details are not submitted to enable HMRC to quantify the possible under-assessment of tax.

Encouragement is given to submit the minimum necessary to make disclosure of an insufficiency. That can be subjective, and therefore problematical, and it may result in scope for successfully arguing that full disclosure was made following that guidance. In particular, if in anticipation of HMRC possibly taking a different view you disclose some background details, be ready to challenge any HMRC attempt to argue that what you disclosed was not full and complete as you merely followed their request that the minimum necessary was disclosed.

On the other hand, the threat is made that where the total amount supplied is so extensive that an officer could not have reasonably expected to be aware of the significance of particular information, it is not full disclosure unless the significance of particular information has been drawn to the tax officer's attention.

Mrs Lavinia Frances Corbally-Stourton v HMRC SpC692

The Special Commissioner included this in his judgment:

"In my judgment for the reasons which follow, the test in the tailpiece of Section 29(5) – the reasonable expectation of the awareness of the situation in subsection (1) – is to be interpreted thus: that the officer could not reasonably have been expected, on the basis of the information mentioned, to have discovered an insufficiency: i.e. to have come to the conclusion that it was probable that there was an insufficiency. I come to that conclusion because the language of the section in referring to the 'situation mentioned in subsection (1) incorporates by reference the idea of a discovery and therefore the concept of a conclusion that it was more probable than not that there was an insufficiency. Thus in my view it is not required that the officer be aware that there was in truth an insufficiency or that he be aware that it was beyond all reasonable doubt that there was an insufficiency, but merely that that information should enable him to conclude on balance that there

was an insufficiency. Again a mere suspicion would not be enough, but, a conclusion in relation to which he had some residual doubt may well be sufficient. If he could reasonably have been expected to have come to such a conclusion before the later of the times mentioned he is precluded from making a discovery assessment".

What this means is that if what has been said in the tax return should have been sufficient, if someone had looked at it, to lead them to believe that the return understated income or gains, there can be no later discovery.

Discovery issues from *Bird v HMRC SpC720*

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

- The issuing of the shares and consequential payment of dividends amounted to the use of a corporate structure to provide an income stream to a minor child, and thereby reduce higher rates of tax. That was a typical situation where the taxation of settlors legislation did apply, and this was consistent with the decision in *Jones v Garnett (Arctic Systems)* where the spouse exemption acted to exclude the settlement provisions which otherwise applied.
- The children did not take part in any commercial transaction. What actually happened is that the grandfather of the minors died and a loan was supposedly made by the minors to the company from monies prospectively owned by them from the estate. The shares were then issued to them.

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

Time limit for amendment to partnership statement - *HMRC v Lansdowne Partners LLP (ChD 18 October 2010)*

A limited partnership carried on business as a fund manager. In August 2005 it submitted its partnership statement for 2004/05, claiming a deduction for certain 'rebated fees', including fees which it had reimbursed to its partners as well as to external investors. In August 2008 HMRC amended the partnership statement on the basis that the fees rebated to partners were not allowable as deductions. The partnership appealed, contending firstly that it was entitled to a deduction for the fees and alternatively that HMRC's amendment was outside the statutory time limit. The General Commissioners accepted both these contentions, and HMRC appealed to the High Court.

In the High Court it was held that the rebated fees did not appear to be 'proper deductions', as they did not appear to be wholly and exclusively for the purpose of the partnership's trade. However, they dismissed HMRC's appeal on the grounds that the commissioners had been entitled to find that the discovery assessment was outside the statutory time limit. The effect of Section 30B(6) TMA 1970 was that the amendment was only valid if, at 31 January 2007, the relevant officer *"could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware that the partnership statement was incorrect".*

On the evidence, the partnership had submitted the relevant information in a letter dated 30 March 2006, so that the commissioners had been entitled to find that HMRC had sufficient information to make a decision whether to raise an additional assessment before the expiry of the time limit.

Contributed by Gerry Hart

Lecture P629 (16.34 Minutes)

Business Tax

Changes to Class 2 NIC payment dates from April 2011

From April 2011, payments for your Class 2 National Insurance contributions become due on 31 July and 31 January, the same as a Self Assessment tax bill.

Payments made by internet/telephone banking, CHAPS, Bank Giro, Post Office or post

You will receive just two bill reminders from HMRC in the year (instead of four bills) in October and April, showing payments due by 31 January and 31 July respectively.

Payment made by Direct Debit

To meet the new due dates, collection of monthly Direct Debit payments will be delayed by HMRC to bring the payment dates into line. This means that:

- for the first year only, monthly Direct Debits will stop for a short period and then start again
- Class 2 contributions due for April 2011 will be requested from your bank in August 2011
- payments thereafter will be monthly unless you choose to pay six monthly from April 2011

A new option to pay by six monthly Direct Debits, collected in January and July each year, will be available from April 2011 for those who do not wish to spread their payments.

For those affected by these changes detailed information will be issued via a series of special mail shots in the coming weeks.

See also www.hmrc.gov.uk/payinghmrc/class2nics.htm

Plant and machinery used in a dwelling-house

This is specifically debarred from entitlement to capital allowances, unless the property is within the furnished holiday lettings regime. A dwelling-house is not defined under tax legislation, and HMRC accepts that university halls of residence and similar facilities are not dwelling-houses for this purpose.

Student accommodation generally does come within the prohibition, but not communal areas or parts to which the students do not have access.

In *HMRC Brief 66/08*, the following example was given:

A student accommodation block has three floors, each with ten en-suite study bedrooms that are individually lockable. Each floor also has a kitchen and TV room which are for the use of the ten occupants. The building has air-conditioning equipment located in the attic and a boiler located in the basement: only maintenance personnel have access to these areas.

In this example, the kitchen and TV room are communal areas and not dwelling houses. The stairs and corridors which give access to other areas are also communal and are not dwelling houses. Tenants do not have access to the roof and attic and so they are not dwelling houses. However, the individual study bed-rooms are dwelling houses.

This view extends to other types of multiple occupancy accommodation, such as those provided to key workers.

That disappeared and instead *para CA23060* of the *Capital Allowances Manual* simply said the following:

"A dwelling house is a building, or part of a building, which is a person's home. A person's second or holiday home is a dwelling house as is a flat that is used as a residence. A block of flats is not a dwelling house although the individual flats within the block may be. University halls of residence, accommodation used for holiday letting, a hospital, a nursing home or a prison are not dwelling houses."

In *HMRC Brief 45/10* they attempted to remove uncertainty – unfortunately by claiming that each student flat in multiple occupation is a dwelling-house, given that the individual study bedrooms alone would not afford the occupants the facilities required for day-to-day private domestic existence. Therefore the communal kitchen and lounge are also part of the dwelling-house according to HMRC but not the common parts of the building such as the common entrance lobby, stairs or lifts.

Example

HMRC has supplied the following example in the amended *para CA23060*:

Bob is a landlord owning a block of residential flats and a nursing home. He buys the following:

- *New cookers for the flats*
- *A new fire alarm system for the block of flats*
- *New beds for the nursing home*

No capital allowances claim can be made for the cookers, but a claim can be made for the other expenditure because none of it is for use in a dwelling house.

The relevant dates are as follows:

- The new view applies to capital expenditure from 22 October 2010.
- For expenditure from 29 December 2008 to 21 October 2010, HMRC will accept capital allowances claims in respect of communal areas either (a) in accordance with *Brief 66/08*, or (b) on the basis of the view previously set out in *para CA23060.*
- For expenditure before 29 December 2008 in respect of claims made in line with *Brief 66/08* in tax returns for open years and filed before 22 October 2010, the claims will not require adjustment.

Contributed by Gerry Hart

Lecture B626 (7.11 Minutes)

Corporation Tax

Rebuilding of premises

In *Moonlight Textiles Ltd v HMRC*, a company (M) arranged for building work at its premises which involved substantial alterations and improvements. It claimed a deduction for the cost of this work.

Following an enquiry, HMRC issued an amendment on the basis that £34,000 of the expenditure should be treated as capital.

M appealed, contending that the expenditure should be treated as a repair.

The First-Tier Tribunal rejected this contention and dismissed the appeal. Applying dicta of Buckley LJ in the (non-tax) case of *Lurcott v Wakely & Wheeler*, CA [1911] 1 KB 905, 'repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion.'

The decision in *Lurcott v Wakely & Wheeler* is now almost 100 years old, but it remains an important authority on the distinction between capital expenditure and revenue expenditure.

Rules concerning taxation of international profits are out for consultation

The consultation on taxation of foreign profits seems to have been grinding on for a long time - three years and counting, and it continues to grow tentacles. The reasons behind the reform are largely around UK competitiveness: The Treasury recently stated that the intention is for the UK to have the most competitive tax regime in the G20. The reform was also needed just to keep up. Japan, for example, has recently introduced foreign profits exemptions, and the US is considering them. There is a global move on the part of Western-style economies to an exemption system for foreign profits, rather than a credit system such as the UK has used.

In slightly more cynical terms, the UK also had to do something following the FII Group Litigation case. The ECJ held that the UK credit system for foreign dividends wasn't compatible with the EU freedoms, particularly for portfolio dividends (where the shareholding is less than 10%).

What we have so far:

- exemptions for most UK and non-UK dividends
- a restriction on tax deduction of interest on intra-group loans (aka: the worldwide debt cap)
- Treasury consents dragged out of the 19th century and renamed as "reporting requirements"
- some initial changes to the rules on controlled foreign companies (CFCs) and ongoing consultation on more changes
- a consultation on exempting branch profits from tax.

Controlled foreign company (CFC) changes

The CFC rules bite on UK companies with an interest of 25% or more in an overseas company which is controlled from by UK persons and resident in a lower-tax jurisdiction (where the tax rate is less than ¾ of the UK tax rate). The UK company pays UK corporation tax on its share of the profits of the CFC, whether or not these are distributed to the UK.

The changes to the rules on CFCs so far are stopgap measures to deal with the consequences of the dividend exemption - for example, a major change has been the removal of the the acceptable distribution policy exclusion, unsurprisingly. There's not much point in excluding CFC profits from UK tax because they are paid up by dividend to the UK, when that dividend is exempt when it's received here.

More changes in CFCs are promised, with some draft legislation due soon, and interim legislation in the 2011 Finance Act. Full legislation changes are expected in the 2012 Finance Act. The process

seems a bit bogged down in the complexities and discussions around how to deal with intellectual property holding companies and financial services companies, but measures that are being considered include:

- a new “commercial justification” test
- increasing the profits threshold (below which you ignore the CFC profits when calculating UK tax) from £50,000 to £200,000.

These are just suggestions at the moment, and others may arise through the consultation process.

Branch exemption

Out of the dividend exemptions has come a call for an exemption of branch profits - this comes largely from the banks and insurance companies, who usually have to operate through branches overseas for regulatory and capital reasons.

At the moment, UK companies are taxed in the UK on the profits of their overseas branches, and receive credit for tax paid by the branch in the country where it is located. It’s not unusual to start operations overseas with a branch because the flipside of this is that the UK company also gets the immediate tax benefit of any losses of an overseas branch. Startup losses of the branch are set against UK profits, instead of just being carried forward against future profits of the branch.

The dividend exemptions now mean that most companies would incorporate a branch when it becomes profitable, so that the profits can be returned to the UK free of tax instead of being taxed in the UK with a credit for overseas tax, having had a UK tax deduction for the start up losses. Incorporating a branch isn’t usually an option for banks and insurance companies, and so they have lobbied for an exemption for branch profits from UK tax in order to have similar advantages to companies with subsidiaries.

The simple solution would be to exempt all branch profits and losses from UK tax.

The simple solution does not, unfortunately, appear to be an option. The next lobbying group to get involved were the oil and gas industry, who are not at all in favour of exempting branch losses from UK tax - the startup costs of oil and gas projects are very high, and the business model relies on relief for those startup losses being available to set against UK tax.

The result is a consultation paper that discussed exempting profits of branches in countries where there is a tax treaty, and only to the extent that primary taxing rights for the profits are in the branch country. Losses would still be available for UK relief. Gains of branches will probably still be UK taxable, although it has been suggested that there could be a deferral of UK tax on the transfer of assets to a branch.

Consultation on branch profits has just closed: watch this space for further developments…

Anne Fairpo, AccountingWeb, 14 November 2010

Torkington v Revenue and Customs Comrs

The appellant was a director and chairman of the company (W), a UK incorporated company, whose principal trade was the specialised design, supply and installation of business envelopes. W was a wholly owned subsidiary of O, and the appellant owned half of O. The appellant obtained a personal loan of C$3 million (Canadian dollars) from A Ltd, repayable with interest at a rate of 12%. On 25 November 2003 the appellant loaned W C$3 million on identical terms with an identical rate of interest. The loan agreements stated that the purpose of the loan was to finance hanger and maintenance facilities at an airport in Canada through a Canadian company, WA, which was wholly owned by UKC, another Canadian company, and in turn a wholly owned subsidiary of WG, in respect of which the appellant owned half of the shares. On 26 November 2003 W loaned C$3 million to WA repayable at an annual rate of interest of 15%. In his self-assessment return for the year ending 5 April 2005 the appellant claimed relief for interest of £143,163.79 paid to A Ltd. HMRC opened an enquiry into the return and thereafter issued a closure notice under TMA 1970 s 28A, and amended the return disallowing the loan interest relief claimed. The appellant appealed against the closure notice and amendment. The issue arose as to whether the interest paid by the appellant to A Ltd was eligible for relief under TA 1988 s 353 by virtue of s 360(1)(b). Relief for interest paid was only available under TA 1988 s 353 if it was interest eligible for relief under ss 359

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to 365. It was agreed by both parties that only s 360(1)(b) could possibly grant relief to the appellant. TA 1988 s 360(1)(b) provides that loan interest was eligible for relief under s 353 if it was interest on a loan to an individual to defray money applied "In lending money to such a close company which is used wholly and exclusively for the purposes of the business of the company or of any associated company of it which is a close company satisfying any of those conditions". HMRC accepted that W was a close company. It argued that the appellant's claim for relief failed for the following reasons: (i) the context in which the word "business" was used in s 360(1)(b) was that of "trade" as it referred back to TA 1988 s 13A(2). Therefore the claim for relief failed because the trade of W was, at all material times, the design, supply and installation of building envelope materials including roofing, wall-cladding, glazing and curtain walling for industrial, commercial and public buildings in the UK and overseas. Whilst W might have had the odd venture outside its mainstream trade, it was not the trade of the company to lend money (overseas or to anyone); (ii) where a company (here W) passed on the monies to a second company (here WA), then that company also had to be a close company in accordance with s 360(1)(b). As WA was a non-resident UK company, it did not satisfy the close company criteria outlined in TA 1988 s 414(1)(a); (iii) the later words of s 360(1)(b) "… or of any associated company of it which is a close company …" would be meaningless and unnecessary if the passing on or lending of the money was automatically a use "wholly and exclusively for the purposes of the business". W was merely an intermediary to provide finance, by way of a back loan, to WA. Thus, as the money was for the ultimate use of the Canadian company's trade it could not be said to have been used wholly and exclusively for the purposes of the W business. The appellant submitted that: (i) the word "business" should not be construed narrowly. The words "for the purposes of …" in s 360(1)(b) were flexible and unrestricted and that the use of the plural "purposes" indicated a wide scope that emphasised that business might comprise several elements. The word "business" in that section was used deliberately to refer to the entire range of activities that a company might carry on; and (ii) the loan from W to WA was for the sole purpose of earning profits by way of a return on the loan and the provision of services to WA. Thus, the use of the loan moneys by W was wholly and exclusively for the purposes of its business. All applicable conditions of TA 1988 s 360 were met as regards the loan from the appellant to W and he was entitled to loan interest relief under TA 1988 s 353; (iii) the directors had always run W in an entrepreneurial manner and included as business activities investments in both UK and overseas projects including, but not limited, property development, capital investments and coal importation—although it accepted that the main activity of W was not investment; (iv) W had first invested in Canada in a joint venture in 1988: UKC which acquired 100% of the share capital of a new commercial operating company, WC, whose objective was to extend its business activities with a view to expansion in North America. The recession meant that construction activities ceased but it continued to receive property rental income. UKC then incorporated a new subsidiary UKCII; (v) the hangar facilities at the Canadian airport was an opportunity to re-establish the W brand and so UKCII was renamed WA; and (vi) in order to obtain funding for W, as commercial lenders were unwilling to lend to it for an overseas development project, he obtained a loan personally from private financiers A, which was conditional upon him providing a personal guarantee. He did not want to loan the moneys direct to WA because it was a W project and he wanted any risk to be shared with the other shareholder. If he had made the loan directly WA would have been required to deduct withholding tax from the interest payment made to him. The decision was made to go ahead with the loan to WA at a three% interest margin.

The tribunal considered that on the correct interpretation of TA 1988 s 360(1)(b), the specific reference to "the purposes of the business", as opposed to the word "trade", was a deliberately unrestricted terminology. Whilst the intention behind the legislation had to be to allow a flexible and wider approach, it was necessary to look at the very specific facts of the case in order to assess whether in fact any "business" in the wider context was carried out by W, or whether it was restricted in its business activities to its principal trade. On the evidence the loans were genuine commercial loans and the making of the loan by W clearly amounted, in combination with its other activities, to carrying on a business. The loan was made in order that W could make a return from the interest and obtain remuneration from design fees. There were no facts upon which to conclude there was duality in its purpose. In those circumstances, it was hard to envisage how that could not be classed as business activity, albeit distinct from the company's main trade, but for the purposes of making profits. All the relevant conditions of TA 1988 s 360 were met as regards the loan from the appellant to W. It followed that the appeal would be allowed.

Appeal allowed.

Is unfair dismissal payment deductible?

An ex-employee has taken his employer company to court and won a claim for unfair dismissal, but is the amount paid allowable as a revenue deduction?

In the case of *Wilson v Clayton* [2005] STC 157, compensation for unfair dismissal was held to be within the £30,000 threshold, i.e. it was treated as employment income in the hands of the recipient. This suggests to us that payment is allowable as a deduction in the profit and loss account.

As the dismissal was wholly and exclusively for the purposes of the trade – i.e. the employee was not fulfilling his role within the organisation – this would seem to point to a legitimate deduction.

It is possible that there are component parts to the total sum. Is it worth requesting a breakdown?

Any advice from *Taxation* readers that would help us to resolve this matter would be very welcome.

Summary of replies

In the case, *Wilson v Clayton* [2005] STC 157, compensation for unfair dismissal was held to be within the charge of ITEPA 2003, s 401.

Income that falls within s 401 includes compensation for loss of office, redundancy payments, damages for dismissal, payment in lieu of notice (PILON) and certain payments made on retirement. These are specific elements of employment income, to which the first £30,000 exemption applies (ITEPA 2003, s 403).

In contrast with s 401, income that falls within ITEPA 2003, s 62 includes salaries, wages, benefits or anything that is paid in return for services performed under an employment contract.

From the employee's point of view, it is most beneficial for the payment to be assessed within s 401, as he is entitled to the valuable £30,000 exemption.

Nevertheless, the tax treatment of the compensation paid to the employee does not necessarily guarantee the deductibility so far as the paying employer is concerned.

There are a couple of hurdles along the path that leads to the deductibility of the payments made.

1. Was the expense incurred by a trader in his capacity as a trader?
2. Was the expense revenue rather than capital?

Getting rid of an employee because of his unsatisfactory performance benefits the ongoing trade as a whole and costs so incurred, therefore, meet the wholly and exclusively condition.

However, the deductibility also depends on whether the compensation paid was intended as a punishment or merely to provide restitution for damages (BIM38500).

As BIM38540 directs, civil damages that are not intended to be punitive may be allowable.

Compensations awarded by a court for unfair dismissals usually follow the Gourley principle, which derives from *British Transport Commission v Gourley* [1955] 3 All ER 796.

The principle ensures that a person seeking compensation is not placed in a better or worse position than he would have been in should the employment contract have been carried out properly.

If the compensation paid followed the Gourley principle, it is more likely to be merely restitutionary instead of punitive.

To conclude, the compensation payment, together with the legal and professional fees incurred in defending its position, is likely to be allowable in computing the trading profit, as the payment is not in connection with an identifiable capital asset and the trade purposes condition seems to be satisfied.

It is difficult to see how termination payments could be capital in nature, unless they are linked to a specific capital asset (e.g. the closure of a business).

Taxation Forum, November 2010

Value Added Tax

Change of rate to 20%

With the VAT rate increasing to 20% from 4 January 2011, what do we need to be aware of?

Tax points

In most cases the normal tax point rules for VAT will apply:

- VAT is due when a customer receives goods or services (known as the 'basic' tax point).
- However, the basic tax point is superseded if an actual tax point is created by either receipt of money or raising a sales invoice, as long as this happens within 14 days of the goods or services being supplied. The actual tax point also applies for advance invoices raised or payments received before goods or services are supplied.
- In the case of an increase in the rate of VAT, the VAT charge can be based on the basic tax point date. So invoices raised in January for goods delivered to a customer in December can still benefit from a 17.5% rate of VAT.
- To avoid any jiggery-pokery when the VAT rate increases, there is anti-forestalling legislation in place, mainly relevant to prepaid transactions exceeding £100,000 (see later).

Advance invoices and payments

Under normal circumstances, where it is normal practice to raise invoices in advance of a service, invoices raised in December 2010 for services to be completed in January can be raised with VAT charged at 17.5% (subject to the anti forestalling rules below)

Sale of goods

Where a deposit is paid in December for goods to be delivered in January, the deposit includes VAT at 17.5%.

How the balance is treated depends on when the customer pays for the goods. If the balance of the price is paid from 4 January 2011 onwards, the 20% VAT rate applies. If on the other hand, the balance is paid before 4 January 2011, then the lower rate of 17.5% applies.

Continuous supply of services

Another very common situation is where accountants and other professionals do regular work for clients (continuous supply of services) and raise an invoice on a periodic basis.

A tax point is created when an invoice is raised or payment received, whichever happens first. If we are raising an invoice for work carried out in the three months to 31 January 2011, we can just charge 20% VAT on the full amount based on the invoice date.

This keeps things simple. Suppose, however, that the client cannot reclaim input tax and is keen to minimise his exposure to non-recoverable VAT. In this situation, a concession within VATA 1994, s 88 allows the measured work carried out up to 31 December to be charged at 17.5% VAT and all work after this date at 20%.

Overlap of services

What happens if a painter and decorator starts a big job for a customer on 15 December but does not finish it until 15 January? In such cases, my advice to the decorator will be to encourage his customer to pay for the job in full before 31 December (to create a tax point that means the entire job will be due at 17.5% VAT).

Failing that, the decorator can raise an advance sales invoice up to 31 December, again creating a 17.5% VAT liability (and improving his profit margin if he quoted the customer for a job figure including VAT).

Even if he does not do this and only raises an invoice or receives payment when he has finished the job, there is still scope to produce a partial VAT gain. This is because he can charge 17.5% VAT on measured work completed up to 31 December, and 20% thereafter.

However, be aware that HMRC will be a bit suspicious if this is done on a simple date-apportioned basis because not many decorators work in the last week of December.

Slow invoicing

What about a trader who sells goods and services but does not get round to raising invoices for his December sales until January?

He can either charge 20% VAT based on the invoice date in January or the lower rate of 17.5% on the basis that the goods were supplied or work was performed before the rate of VAT increased.

Flat rate scheme

The flat rate percentages will be revised to coincide with the rate increase on 4 January so make sure that your clients use the correct rate going forward.

The challenge for scheme users will be to make two flat rate calculations if a VAT period overlaps 4 January.

Cash accounting

The key point with the cash accounting scheme is that it does not change the tax point as far as VAT is concerned, but only the time when VAT charged on a sale is entered on a VAT return; i.e. usually from the earlier invoice date to the later date of payment.

Credit notes

A credit note must be based on the same rate of VAT as the original sale. This is reasonable, otherwise there would be some unfair VAT windfalls being enjoyed after 4 January.

Anti-forestalling legislation

The number of transactions that will be affected by the legislation should be very limited in practice. The relevant legislation here is contained in FA 2009, Sch 3.

The starting point is to consider whether an advance invoice is being raised or advance payment received before 4 January, but where goods or services are supplied after this date.

If so, the next question to consider is whether the customer can reclaim all of the VAT charged as input tax on his own returns. Answer 'yes' to this question and there is again no problem.

However, if you still have a problem, then a 'yes' answer to one or more of the following questions means the sale will be subject in most cases to an extra 2.5% supplementary VAT charge on 4 January:

- Is the value of the sale (and any related sales) more than £100,000 (excluding VAT)?
- Are the customer and supplier connected to each other?
- In the case of an advance invoice (but not an advance payment), is payment due more than six months after the invoice is issued?
- In the case of a prepayment arrangement, is the supplier, or anyone connected to the supplier, financing the prepayment?

Even if your transaction fails one or more of the anti-forestalling tests above, then all is not lost. If your sale involves the letting, hiring or rental of assets and the advance invoice or payment is 'normal commercial practice' for the supply in question, then you will not have a problem.

Adapted from an article by Neil Warren

VAT issues when converting or renovating property

a) Converting commercial properties to houses or flats

Onward supply

The zero-rating legislation will apply to the first grant of a major interest by a person converting a non-residential building or a non-residential part of a building into a building designed as a dwelling or number of dwellings or intended for use solely for a relevant residential purpose. This might be where someone is converting a warehouse building into flats or a barn into a house.

Provided the other conditions above are met, zero-rating also applies to the sale of, or grant of a long lease in, land that will form the site of a building provided a building is clearly under construction or conversion.

If the major interest grant is not present then the onward supply will be exempt e.g. 12 month rental tenancies.

Purchase of commercial property

The purchase of a commercial property will be exempt. If an option to tax is in force the buyer will need to provide a certificate to the seller (on or before exchange) to secure exemption. The certificate should confirm the extent of dwelling use going forward e.g. two floors out of three. The option is only disapplied to the extent of dwelling use e.g. two thirds.

Disapplying the option to tax will be useful to reduce the SDLT charge and to improve cash flow. It does also reduce the risk of irrecoverable VAT should the buyer not make any onward taxable supplies with the converted property.

Conversion work

VAT should be charged at the reduced rate of 5% on qualifying services supplied in the course of certain residential conversions. Generally the lower rate will apply to commercial property being converted to flats.

Building materials and certain electrical goods, supplied by the person providing the above services and incorporated into the building in question or its immediate site, are also subject to the reduced rate.

Building materials supplied in isolation will be standard rated.

Deduction of input tax

Providing an onward zero rated supply is made the VAT incurred on the conversion work is recoverable.

b) Converting houses to flats

Onward supply

The onward sale will be exempt.

If the house has however been empty for 10 years or more the sale can fall within the zero rated provisions as a qualifying conversion.

Purchase of the house

The purchase of a house will be not be subject to VAT.

Conversion work

VAT should be charged at the reduced rate of 5% on qualifying services supplied in the course of certain residential conversions. Generally the lower rate will apply to houses being converted to flats as the number of dwellings is changing.

Building materials and certain electrical goods, supplied by the person providing the above services and incorporated into the building in question or its immediate site, are also subject to the reduced rate.

Building materials supplied in isolation will be standard rated.

Deduction of input tax

Input tax will not be recoverable as the onward supply is generally exempt.

c) Renovating houses to sell or let on

Onward supply

The onward sale or let will be exempt. The sale can however be zero rated if the house has been empty for more than 10 years.

Purchase of the house

The purchase of a house will not be subject to VAT.

Renovation work

The services in connection with the renovation or alteration of a single household dwelling that has not been lived in for two years or more when the work commences (or at time of purchase) are subject to VAT at the reduced rate of 5%.

Building materials and certain electrical goods, supplied by the person providing the above services and incorporated into the building in question or its immediate site, are also subject to the reduced rate.

Building materials supplied in isolation will be standard rated.

Deduction of input tax

Input tax will not be recoverable as the onward supply is generally exempt.

Lecture B629 (16 Minutes)

Benefits and salary sacrifice

Taxable benefits: general principles

The income tax treatment of non-cash remuneration has been examined by the courts and refined by legislation over a long period. The VAT treatment is less well defined. The following points have arisen in a variety of disputes:

Where the item provided to an employee is purchased by the employer and carries VAT, the employer has to consider:

- whether it is possible to claim input tax on the purchase – under general principles, it must have been purchased for the purposes of the business and must have a link to making taxable supplies;

- whether it is then necessary to account for output tax on the onward supply to the employee – this will be so in three circumstances:
- where the employee gives the employer consideration for the transfer;
- where the supply constitutes "goods" and is subject to the rules in Sch.4 para.5 VATA 1994;
- where the supply constitutes "services" and is subject to the rules in SI 1993/1507.

If the employer can deduct input tax but does not have to account for output tax, that creates an obvious tax advantage. This has been held to be the case:

- in relation to staff parties which are intended to provide an incentive to staff – 100% of the input tax is deductible without any output tax (Ernst & Young, VTD 15100 1997);
- in relation to tickets given to employees as part of an employee suggestion scheme or as rewards for 100% attendance (Peugeot Motor Co plc, VTD 16731 1999).

There are specific rules to disallow input tax deduction on the purchase of a company car where there is the mere possibility of private use; there are also specific rules which require an output tax charge where an employer claims input tax on the purchase of fuel which is provided free of charge to an employee for private motoring; but if an employer incurs other expenses in relation to a car that is used partly for business and partly privately, the employer can deduct all the input tax without accounting for output tax.

Where an employee makes a payment to an employer for the provision of a benefit, it ceases to be a benefit and becomes something that has been purchased by the employee out of taxed salary. The borderline between "making a payment" and "agreeing a remuneration contract" was considered in Co-Operative Insurance Society Ltd (VTD 7109, 1992). The one-off agreement of a remuneration package was held not to constitute consideration for the provision of a company car. The employee was stuck with the decision made at the beginning of the year, whether the car was then used or not (there was no question of a pay rise if the employee was banned from driving). In the view of the Tribunal, there was therefore no direct and immediate link between the salary forgone and the provision of the car. This was subsequently given statutory effect for the provision of cars by SI 1992/630. It is also accepted in the HMRC VAT Consideration and Supply manual at VATSC49200.

HMRC have recently commented that they are examining so-called salary sacrifice schemes to see whether employers have implemented them properly.

If the adjustment to salary appears on the payslip rather than being the kind of one-off agreement in advance that was effective in Co-Operative Insurance, HMRC will regard:

- the gross salary including the sacrifice to be subject to income tax as if paid in cash, including obligations for PAYE and NIC;
- where the sacrifice is in exchange for something which constitutes a taxable supply for VAT purposes, VAT will be due.

Cycle-to-work scheme

There is an interesting comment on the VAT consequences of a particular benefit in the Department for Transport guidance on the "cycle to work" scheme. The last government offered an incentive to employers and employees to replace car commuting by cycling: if the employer buys and loans a bicycle to an employee who uses it mainly for commuting, there is no benefit subject to income tax. Some employers have therefore set up a variation on the following arrangement:

- employee chooses a bicycle which costs say £1,000;
- employer purchases it and lends it to the employee for a year;
- employee agrees a salary reduction of £1,000 for the year;
- employee therefore has a bicycle which would have had to have been purchased out of net salary, but instead is purchased out of gross salary;
- the employer has provided the bicycle for nothing.

The main things that can go wrong for direct tax purposes are:

- the employee does not satisfy the "mainly for commuting" requirement;
- the salary sacrifice is done incorrectly, which means that the employer is not "loaning the bicycle" but rather charging for the use of it.

The DfT guidance states in section 7:

Where an employer purchases or leases cycles and cyclists' safety equipment, VAT will be incurred on the cost, barring crash helmets which are zero rated, at the point of purchase or on leasing payments for that equipment. Where the equipment is for use in a Cycle to Work scheme for employees, HMRC accept the VAT incurred is for the purpose of the business of the employer and may be treated as input tax, subject to the usual rules on VAT recovery. The benefits to business are seen as attracting, retaining and motivating employees and promoting a healthier workforce. However, where a participating employer is either not 'in business' – this may apply to charities and public sector bodies – or the employer's business is partially exempt, input tax recovery may be wholly or partly restricted. For fuller guidance on the recovery of VAT, please refer to HMRC website http://www.hmrc.gov.uk or contact HMRC National Advice service on 0845 010 9000.

Provided the equipment is loaned to the employee for no charge or under a salary sacrifice arrangement then no output tax is due. "Salary sacrifice" occurs where an employee foregoes part of their salary for optional benefits provided by an employer. Employees choosing to take a benefit have their employment contracts amended or enter into new contracts in order to reflect the new provisions and reduce gross salaries accordingly. The "reduction" does not represent consideration for a supply. It is, however, important to note that "salary sacrifice" is not the same as deduction from salary. Where a charge is made against a salary and deducted from it the charge is consideration for the benefit given in return and output tax is due in the same way that it is for any supply made for a consideration.

For fuller guidance on "salary sacrifice" please refer to the HMRC web site http://www.hmrc.gov.uk/specialist/salary_s.

If at the end of the salary sacrifice period the employee is given an option to purchase the equipment and they choose to do so then any charge made will be liable to VAT.

http://www.dft.gov.uk/pgr/sustainable/cycling/cycletoworkguidance/pdf/518054/

Shoots for director

A company organised 12 commercial game shoots per season on an estate for VATable consideration of £8,000. It also provided its sole director with 12 private shoots for no consideration; one of these was "given to charity". HMRC argued that the director provided his services to the company in consideration for the shoots, and the value of this non-monetary consideration should be set at the same level as the commercial shoots. The company was therefore assessed to output tax as if the director had paid the going rate for all the private shoots.

The company recovered input tax on the catering costs associated with the private shoots. The director said he was unaware of this. The company also declared the cost of providing the private shoots (about £1,000 each) on his P11D as a taxable benefit provided to an employee.

The Tribunal examined ECJ precedents including Apple and Pear Development Council, Tolsma and Julius Filibeck. The principles of linking supplies and consideration were summarised as follows:

(1) The recipient derives a specific identifiable benefit from the services supplied (Apple and Pear Development Council).

(2) The value given and the service provided constitute mutually dependent elements of a bargain struck between the parties (Tolsma).

(3) The consideration given must be quantified or quantifiable (Tolsma).

(4) There must be a real connection between the service supplied and the consideration (Julius Fillibeck).

On that basis, the Tribunal concluded from the facts that the shoots were provided to the director in exchange for his services as director. He derived no other benefit from his ownership of the

company, and it appeared that he would not have bought the shareholding apart from the opportunity to enjoy the shooting.

On the question of valuation, the Tribunal applied the principle of Naturally Yours Cosmetics: if there is a subjective agreement between the parties (in this case, the company and the director) of the value, then it will be used for VAT. The onus is on the appellant to show that there is a subjective agreement, and that was satisfied in this case by the existence of the P11D entries. The onus was then shifted to HMRC to show that this was unreasonable or did not represent the true agreement. HMRC had not done so. The assessment was therefore reduced to reflect a total gross value of £12,000 per season instead of £96,000 per season.

On the other hand, the misdeclaration penalties (reduced for the smaller base figure) were confirmed. No more than the 70% mitigation already allowed was appropriate. The excuse offered – that the matter was complicated and the appellant could not be expected to understand it – amounted to ignorance of the law, which could not be an excuse.

First Tier Tribunal (TC00607): Thimbleby Farms Ltd

Vouchers for staff

The ECJ's judgment in the AstraZeneca case has cast doubt on the proper tax treatment of all salary sacrifice schemes. The Advocate-General's opinion was more detailed in its consideration of the issues, and that is therefore described in detail below; but the judgment agreed with its overall conclusion.

The background to the dispute is a flexible remuneration scheme operated by AstraZeneca for its employees. The company offers staff the choice of receiving some of their remuneration in the form of retailer vouchers. Typically these are "sold" to the employee by an agreement to reduce gross salary – a "salary sacrifice". If this is done properly, the top line of the payslip is reduced, and no deduction appears on the payslip. The employee typically will "pay" a discounted amount for the vouchers, reflecting the discounted cost paid by the company for their purchase. The sacrifice might be £900 for £1,000 of vouchers at face value.

There are specific income tax rules in the UK that will make the direct tax consequences the same as receiving the cash. However, the VAT treatment is less clear.

Typically the supply of the vouchers would involve the following steps:

- the retailer issues them to an intermediary at a discounted value, say £8 for a £10 voucher – not charged to VAT at that time;
- the intermediary sells them to AstraZeneca for a higher price, say £9 – this is chargeable to VAT, with two complications:
- the intermediary is entitled to deduct a notional amount of input tax reflecting the output tax that the retailer expects to account for on the redemption of the voucher, so the intermediary's VAT payment is based on the margin of £1 rather than the output of £9;
- the VAT rate applied reflects the proportion of standard rated and zero-rated redemptions estimated by the retailer, so the invoice issued to the company will not show output tax at 7/47 of £9 but a lower figure;
- AstraZeneca agrees the salary sacrifice arrangement with the employee and effectively recovers the £9 cost by paying gross salaries reduced by that amount.

AstraZeneca decided that it should be entitled to claim input tax on the intermediary's invoices without accounting for output tax on the "supply" to the employees. This was based on the following assertions:

- the purchase was for business purposes, being the provision of incentives to staff, and was therefore recoverable according to the rules of partial exemption as an overhead;
- the transfer to the employees was for no consideration, because there was no direct and immediate link between the salary sacrifice and the transfer of vouchers in line with the UK Tribunal's decision in Co-Operative Insurance Society Ltd.

HMRC disputed the right to claim input tax without an output tax charge. The matter was referred to the ECJ. The questions referred were:

1) In the circumstances of this case, where an employee is entitled under the terms of his or her contract of employment to opt to take part of his or her remuneration as a face value voucher, is Art.2(1) 6th Directive [now Art.2(1)(c) of the Principal VAT Directive] to be interpreted such that the provision of that voucher by the employer to the employee constitutes a supply of services for consideration?

2) If the answer to question 1 is no, is Art.6(2)(b) [now Art.26(1)(b)] to be interpreted as requiring the provision of the voucher by the employer to the employee in accordance with the contract of employment to be treated as a supply of services, in circumstances where the voucher is to be used by the employee for his or her private purposes?

3) If the provision of the voucher is neither a supply of services for consideration within the meaning of Art.2(1) nor is to be treated as a supply of services under Art.6(2)(b), is Art.17(2) [now Art.168] to be interpreted so as to permit the employer to recover the value added tax it has incurred in purchasing and providing the voucher to the employee in accordance with the contract of employment in circumstances where the voucher is to be used by the employee for his or her private purposes?

The Advocate-General considered that the supply of the vouchers should be treated as a taxable supply by the employer for consideration (i.e. the answer to Q1 is "yes"). This would mean that the VAT system would operate in accordance with its normal principles, and the employee (as final consumer) would bear the proper amount of VAT in a purchase.

The opinion went on to say that if the full Court disagreed with this answer to Q1, the conditions for a deemed supply under art.26 are not met. The transaction in which the employee forgoes some pay in return for the voucher cannot be regarded as a supply for no consideration.

If the third question had to be answered, the Advocate-General's opinion was that there should be no input tax deduction for the employer if there is no output tax charge. This would be an irrational result, and could only be acceptable if it was the only possible interpretation of the law. The Advocate-General believed that the law should be interpreted in a way that produces the rational result – preferably output tax on the supply of the vouchers, but if not, neither input tax nor output tax. The full court agreed with the opinion on the first question, so the third question did not arise.

The Commission also argued that a supply of vouchers should be regarded as a supply of goods or of services, depending on what the voucher was subsequently used to obtain. The Advocate-General commented on this view, even though it was not necessary in order to deal with the questions referred. He considered that it would lead to greater complications as it would not be possible to determine which rules to apply until later than the time of supply. He also set out a clear legal basis for regarding the supply of vouchers as a supply of services, whether or not they could be used to buy goods. Again, the full court agreed with the opinion on this.

The judgment is therefore that the employer is entitled to input tax deduction in respect of amounts paid for the vouchers, but must account for output tax on the supply to the employees.

ECJ (Case C-40/09): AstraZeneca UK Ltd v HMRC

An article in Taxation, 23 September 2010, reviews the current state of salary sacrifice schemes, which appear to be under attack by HMRC in the UK at the same time that the ECJ has opened up a new "front" with the AstraZeneca decision.

Taxation 23 September 2010

Contributed by Mike Thexton

Lecture B630 (31.00 Minutes)

Changes to Lennartz accounting from 1 January 2011

Under existing arrangements, VAT on assets such as land and property, ships and aircraft is recoverable upfront on both the business (subject to any restriction in relation to exempt supplies) and private use of the asset. VAT is then payable in subsequent years in respect of the private use of the asset. This is known as Lennartz accounting and provides taxpayers with a cash-flow benefit.

EU Council Directive 2009/162/EU takes effect from 1 January 2011 and requires Member States to restrict VAT recovery in relation to the private use of land and property related expenditure. It also permits Member States to restrict VAT recovery on other assets and, as announced on 24 March 2010 and confirmed on 22 June 2010, the UK will exclude ships and aircraft. Changes to the Capital Goods Scheme will also be permitted by this legislation to take account of changes in private use in subsequent years.

Until a recent policy change arising from the decision in VNLTO, many taxpayers were wrongly permitted to use Lennartz accounting (see Revenue and Customs Brief 02/10). This legislation ensures that, where these taxpayers choose not to unravel these arrangements, there is a statutory obligation to continue to account for the VAT due under the Lennartz arrangements. The legislation ensures that this obligation has always had effect.

Current legislation relating to the recovery of VAT on directors' accommodation becomes redundant as the Directive and related European case law ensures that there is no entitlement to any VAT recovery on the private use of such accommodation. This legislation will be removed.

Specifically Finance Bill (No 2) 2010 Clause 19 and Schedule 8 provide for:

- amendments to Value Added Tax Act 1994 (VATA) to implement the basic requirements of the EU VAT Technical Directive ("the Directive"). These remove a taxpayer's ability to reclaim VAT paid on expenditure on land and property to the extent that it is used for private purposes ("Lennartz accounting"). Under an option granted by the Directive, they also remove the ability to use Lennartz accounting for ships and aircraft. The use of Lennartz accounting for these assets is replaced by the ability of a taxpayer to adjust for subsequent changes in private use under the Capital Goods Scheme;

- a related minor change to section 24 of VATA to bring the rules relating to VAT recovery on directors' accommodation into line with EU law; and

- legislation to protect revenues tied up in existing Lennartz accounting arrangements following a change in policy as a result of the European Court of Justice (ECJ) decision Vereniging Noordelijke Land – en Tuinbouw Organisatie Case C-515/07 (VNLTO).

Changes to the Capital Goods Scheme from I January 2011

HMRC issued a Brief on 3 November 2010 concerning changes to the Capital Goods Scheme (CGS) which are due to apply for expenditure on or after 1 January 2011.

Comments on the draft legislation were invited by 30 November 2010.

The key changes are outlined below.

1. Widening the scope of the CGS to include non-business VAT – brings VAT relating to non-business activities into the CGS and requires businesses to review their 'business non-business' (BNB) calculation (in addition to the current requirement to review the PE calculation) at the end of each year for CGS items.

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2. Define CGS items by reference to VAT-bearing capital expenditure (rather than input tax-bearing expenditure) – as the CGS is to be widened to include VAT relating to non-business activities, the definition of a CGS item should include the corresponding amount of VAT bearing expenditure relating to non- business activities (otherwise assets with significant non-business use might be excluded from the CGS).

3. Widening the scope of the CGS to include ships and aircraft that cost £50k or more (VAT bearing capital expenditure) – this will replace the quarterly adjustments (for those taxpayers operating Lennartz accounting) with an annual CGS adjustment. Taxpayers whose ship or aircraft costs less than £50k will not be affected and will not undertake any adjustment to account for changes in use of their asset.

4. Widening the scope of the clawback / payback rules to cater for changes in business use of assets – this change brings non-business activity into the clawback/payback rules (another adjustment mechanism). These rules apply where business related costs are provisionally claimed or not claimed on the basis of an intended supply, but before that intention comes to fruition, there is either a change of intention or the costs are actually used to make a supply of a different VAT treatment. The rules require that VAT on the relevant costs are reallocated. (So, for example, a business cannot claim back VAT on a cost that it intends to use for VAT exempt purposes. However, if there is a subsequent change of intention and the business decides to use the cost to make a taxable supply, it would be entitled to 'clawback' (ie: recover) the VAT from HMRC.)

5. Excluding costs incurred after 1 January from the value of deemed supplies under Lennartz accounting – this prevents costs (on assets falling within the Technical Directive) incurred on or after the 1 January from being included within the value of the Lennartz private use charge. This ensures that in transitional cases (an asset straddling 1 January), where the business has chosen to claim Lennartz accounting for the pre-Jan costs, then the Lennartz VAT on private use charge is computed by reference to just those costs. This prevents double taxation.

They have also sought to simplify partial exemption and capital goods scheme generally. The key simplifications are:

1. Combined BNB PE method – gives taxpayers the option of seeking approval for a combined method for determining their BNB and PE calculations – effectively widening the scope of the current PE special method regime.

2. Ignoring insignificant CGS adjustments – a mandatory requirement that taxpayers using the CGS ignore insignificant adjustments where:

   - total VAT bearing expenditure on CGS item is £1m or less and adjustment percentage is 10% or less; or

   - total VAT bearing expenditure on CGS item is £10m or less and adjustment percentage is 5% or less; or

   - adjustment percentage is 1% or less.

Change in the VAT treatment of business entertainment of overseas customers

HMRC have reviewed its policy on the treatment of business entertainment provided to overseas customers in the light of the European Courts of Justice (ECJ) judgment in the joined case of Danfoss and AstraZeneca (Case-371/07) [2009] STC 701.

<u>The UK position on the entertainment of overseas customers</u>

The UK has blocked the recovery of input tax on business entertainment since the inception of VAT. The terms of the block denied recovery of such input tax except where the business entertainment was provided to an overseas customer. In 1988 UK law was amended to extend the block to cover all business entertainment including that provided to overseas customers. This change was made to align VAT law with changes introduced in relation to direct tax.

In the light of recent ECJ judgments HMRC has concluded that the UK's block on the recovery of input tax on the business entertainment of overseas clients is inconsistent with EU law. The Government intends to amend UK law shortly. In the meantime HMRC will consider claims for previously restricted VAT in respect of the entertainment of overseas customers, as a direct effect of EU law.

The block on recovering input tax on entertainment provided to anyone other than an overseas customer, for example, UK customers and non-UK business contacts who are not customers, remains effective and any VAT incurred on the costs of such entertainment cannot be recovered.

<u>Making Claims: Time limits</u>

You may make claims in respect of input tax on the costs of entertaining overseas business customers, subject to the normal four year cap. HMRC announced in March 2009 that, pending the outcome of its review of policy in this area, it was inviting claims for such input tax incurred between 1 August 1988 (the date when UK law was amended) and 30 April 1997 (as prescribed following the Fleming judgment). HMRC will no longer accept claims for this period.

VAT incurred in future tax periods in respect of the entertainment of overseas business customers can be recovered in the usual way.

All claims are subject to the qualifications set out below.

<u>Making Claims: Evidence required</u>

HMRC expects that, as a minimum, claims are supported by the following evidence:

- details of the overseas customers
- the type of expenditure, for example, meals to support business meetings, etc.
- the amount of VAT claimed
- evidence that VAT has been incurred and not previously been deducted
- if required for historical claims, evidence of the type of business entertainment the business normally excludes from recovery by reference to recently rendered tax periods.

<u>What VAT can be recovered in respect of entertainment?</u>

HMRC now takes the view that VAT incurred on the entertainment of overseas customers may be recovered under the terms of EU law. However, in some circumstances an output tax charge to reflect private use arises and cancels out any deductible input tax. Where that is the case, there is no benefit in making a claim, so in considering whether to claim you should also consider whether there is a charge to output tax.

Private use charge

The charge that taxes private use is intended to ensure that the taxable person, his/her staff and others do not achieve an advantage over private individuals simply because the taxable person is registered for VAT and can recover VAT incurred on costs. The ECJ has addressed the question of the applicability of such a charge and it is clear from two particular decisions that the circumstances under which an individual can benefit privately from a business expense without a private use charge arising should be very narrowly defined. The two cases - Julius Fillibeck Sohne C-258/95 [1998] STC 513 and Danfoss and AstraZeneca C-371/07 [2009] STC 701 - introduce separate tests that should be applied to private use of business expenditure; these are set out in more detail below. As no advantage arises if the VAT is not recovered by the taxable person there is no need to consider the applicability of the private use charge unless you intend to recover the VAT paid.

In the Fillibeck Sohne case an employer provided transport to his staff to get them from their homes to a construction site. As commuting expenditure is private, the Court was asked to consider whether having recovered tax on the cost of the transport it was appropriate to apply a charge to reflect the private use by the employees. The Court's starting point was that a charge applied in principle but they considered the particular facts of the case and concluded that because it was practically impossible for the employees to get to the site on their own a private use charge should not be applied. From this judgment we must therefore consider whether it is necessary for the taxable person to provide goods or services that are enjoyed privately in order for him to make his taxable supplies; this is **the necessity test**.

The joined case of Danfoss and AstraZeneca involved the provision of free meals to both employees and business contacts. In the context of the business having recovered VAT on the meals, the ECJ was asked to consider whether it was appropriate to apply a private use charge. The Court concluded that where the meals were provided for a strict business purpose no such charge should arise. In reaching this conclusion they carefully considered the circumstances of the free meals. In particular the lack of choice by the recipient of what, when and where to eat, the relatively basic nature of the fare and crucially the fact that the meals were provided to ensure the smooth running of business meetings; this is **the strict business purpose test**.

These cases set out the circumstances where it is and is not appropriate to apply a private use charge to a benefit provided by the business. HMRC considers that unless there is a necessity for the business to provide entertainment or there is a strict business purpose behind it, such as the facilitation of a meeting, it is appropriate to apply a private use charge to entertainment provided to overseas customers.

If you conclude that the entertainment you provide should trigger such a private use charge, HMRC suggests that you treat the VAT incurred as non-deductible instead, rather than claiming a deduction and offsetting this with an output tax charge. This approach is consistent with the view that VAT incurred on the entertainment of overseas customers should only be recovered where it is clearly used for the making of taxable supplies as well as being reasonable in scale and character.

We set out below a number of scenarios that should assist in deciding the correct VAT treatment of any expenditure that you have incurred on entertaining overseas customers.

Meetings in your office

HMRC considers that where you entertain overseas customers in your staff canteen or similar, and the entertainment is provided to facilitate a business meeting, then the VAT on such expenditure will be recoverable and no charge to reflect the private use will arise; we take the view that any private benefit derived by your overseas customer is accessory to the needs of your business. This approach satisfies the basic input tax recovery test by establishing a link between the expense and the taxable supplies that your business makes. It is also consistent with the approach adopted by the ECJ in assessing the applicability of any private use charge in that this expense has a strict business purpose.

External meetings/events

Where you cannot host meetings in the office because, for example, you have a large number of attendees or you have no in-house facilities, then you can still use the principles set out above to determine if your input tax is recoverable or there is a charge to output tax under the private use charge. The provision of basic refreshments at, for example, a training event or a meeting will be treated as if it were supplied by your own in-house canteen. However, where the provision goes beyond merely providing basic food and refreshment to facilitate the smooth running of the event, then you should not recover any input tax or, failing that, account for output tax under the private use charge.

Corporate hospitality events

Many businesses offer their customers or potential customers general entertainment and hospitality, for example, golf days, track days, trips to sporting events, evening meals, trips to night clubs. HMRC will generally not allow deduction of VAT in respect of these events or will require you to account for output tax, as such events are unlikely to have a strict business purpose and be necessary for the business to make its supplies.

Revenue and Customs Brief, 03/11/2010
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