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Finance Bill 2011

Saving grace for furnished holiday lettings (FHL)

The Chancellor announced in the June 2010 Emergency Budget that previous plans to abolish the FHL tax regime from April 2010, were to be scrapped. The Government did, however, concede that the existing rules needed to be amended. A period of consultation followed and draft legislation has now been published in Finance Bill 2011, that will bring about changes to the regime from April 2011.

The principle behind the reforms is to ensure the regime applies equally to properties in the European Economic Area (EEA), thus making the rules fully compliant with European Law, although further amendments have also been considered during the consultation.

As anticipated, the availability of tax losses arising from FHL businesses (specifically the ability to offset losses against general income) will be restricted. From April 2011, losses from FHL lettings will only be available to be set off against the same UK or EEA FHL business.

It has also been confirmed that as previously announced, the number of days that qualifying properties have to be available for and actually let are set to be increased and this will make it harder for many businesses to qualify under these rules. The minimum period over which a qualifying property must be available for letting to the public in the relevant period will increase from 140 days to 210 days in a year. The minimum period over which a qualifying property is actually let to the public in the relevant period will be increased from 70 days to 105 days in a year. The good news is that contrary to the previous proposals, however, these measures will not take effect until 6 April 2012.

In addition, as a result of the consultation, a new provision will be introduced that will allow businesses to elect to treat a property as continuing to qualify where otherwise it would fail to meet the 105 day 'actually let' requirement. This 'period of grace' will be available for up to a maximum of two years after at least one full qualifying year, provided there was a genuine attempt to let the property during the grace period.

VAT and other indirect taxes

Positive result for business samples

New legislation will be introduced to remove any VAT cost to businesses providing samples of their products free of charge for marketing purposes (see HMRC Brief 51/2010).

This change is necessary following a recent decision in the European Court of Justice (ECJ) which ruled that the UK's current policy is not compatible with European Union (EU) law. Prior to the decision, HMRCs policy was only to allow VAT relief for the first sample, and consequently require the supplier to account for VAT on the second and subsequent samples to the same person or organisation.

Although the UK legislation will be changed from the date that the proposal receives Royal Assent, businesses will be able to rely on the direct effect of the EU law. Therefore, where taxpayers have been required to account for VAT on samples unnecessarily, they should lodge a claim as soon as possible with HMRC for a refund of the overpayments made in the last four years.

At the time that the ECJ considered the VAT treatment of samples, it also confirmed that the UK's rules on the VAT treatment of business gifts are broadly correct. That means that HMRC can continue to limit the numbers and value of business gifts that can be provided by a business VAT free.

Printing matters for VAT treatment

The supply of certain 'printed matter' is subject to VAT at the zero rate. However, new legislation is planned to curtail the avoidance of VAT where printed matter is supplied in conjunction with another service.

The change will mean that the zero-rate will be amended to exclude a supply of printed matter connected with a supply of services made by a different supplier. For these purposes, the supplies of

printed matter and services will be connected if, had they been made by a single supplier, they would have been treated as a single standard-rated, reduced-rated, or exempt supply under the VAT rules.

This measure will have effect from the date that the Finance Bill receives Royal Assent.

VAT change levels the playing field for schools

The education sector has received some good news with the announcement that new legislation will be introduced to allow Academies to recover VAT incurred on purchases made to support their non-business activities (such as the provision of free education) which would ordinarily have been recovered by the local authority.

Local authorities can recover VAT on their non-business activities (such as the running of schools) through a special refund scheme permitted by the UK VAT legislation. Academies are not local authority controlled schools and consequently they do not fall within the special scheme.

This change will apply to relevant VAT costs incurred on or after 1 April 2011.

Duty changes are not small beer

The Government has previously announced its commitment to reviewing alcohol taxation and pricing to tackle problem drinking. The intention is to encourage the industry to produce, and drinkers to consume, lower strength beers.

As part of that strategy, planned legislation will introduce a new duty on beers exceeding 7.5 per cent alcohol by volume (abv) that are produced in, or imported into the UK. The new duty will be levied in addition to the existing general duty on beer.

The legislation will also change the taxation of low strength beers by introducing a reduced rate of general beer duty at or below 2.8 per cent abv.

Beer brewed for home consumption will continue to be exempt from both general beer duty and the new high strength beer duty.

These changes are planned to take effect in autumn 2011. The exact date of implementation will be announced following discussion with the industry.

Information powers

The Government has also issued further details following a consultation earlier this year on gathering 'bulk and specialist information' and has issued a further consultation on 'data-gathering powers'.

This looks at changing the legislation to increase HMRC's powers to gather information from 'data holders', which is defined quite widely to include anyone who pays fees, commissions or other amounts to self-employed individuals as well as banks and letting agents.

These changes are proposed to be introduced from 1 April 2012 and will lead to a significant increase in HMRC powers.

Employer update

HMRC comes out fighting in war against persistent rule breakers

HM Revenue & Customs (HMRC) is seeking to increase its powers against employers who continue to flout the rules with regards to payments of PAYE and subsequently, National Insurance contributions.

A consultation document has now been released alongside draft legislation that will seek to provide HMRC some level of security for outstanding payments. Those offenders failing to comply with the new measures may be liable for fines. Further, the non-payment of a security will be a criminal offence.

The measures are part of the Government's endeavours to bring about a 'fairer tax system'. If you’re a business that is not involved with any of these issues, then the proposals should help level the playing field by making it harder for some disreputable businesses to avoid paying their liabilities.

Employer-supported Childcare (ESC)

Amendments have been announced in the draft Finance Bill 2011, which will mean that employers using flexible benefit or salary sacrifice arrangements may withdraw ESC schemes from those individuals earning at or near the national minimum wage (NMW) and the scheme will still continue to be eligible for tax relief.

In order to benefit from the tax reliefs available for ESC schemes, a business must meet several conditions, one of which requires that a scheme must be open generally to all employees. However, many employers offer such schemes as part of a salary sacrifice or flexible benefits package that cannot be offered to employees who earn at, or near, the NMW, thus disqualifying the ESC scheme from being available for relief.

The draft proposals, therefore, amend these conditions to allow tax relief where employers choose to exclude those earning at or near NMW levels from an ESC offered through a salary sacrifice or flexible benefit arrangement. These amendments will take retrospective effect, to apply from the tax year 2005/06, when the tax relief was first introduced.

..but doors closed on higher rate tax relief

Further proposals are included within the draft Finance Bill 2011 that will see a restriction to the level of income tax relief available for individuals joining ESC schemes who are higher rate or additional rate taxpayers (ie earning in excess of £42,475 in the tax year 2011/12).

Employees can currently receive qualifying childcare vouchers of up to £55 per week free of income tax and National Insurance contributions (NICs) (subject to certain conditions). Under current arrangements, however, employees on higher earnings receive a greater tax saving than those who pay tax at the basic rate.

The proposals will see a reduction in the amount of childcare vouchers which can be supplied exempt from income tax and NICs to higher rate and additional rate taxpayers, which effectively equalises the amount of tax saving available for all employees. This is another example of the Government's measures to bring about a 'fairer tax system'. The maximum amount of childcare vouchers taxpayers will be able to receive exempt from tax will be as follows:

Taxpayer	Basic rate	Higher rate	Additional rate
Weekly	£55	£28	£22
Monthly	£243	£124	£97
Annual	£2,915	£1,484	£1,166

The changes will only affect individuals who join an ESC scheme on or after 6 April 2011. Those already in an ESC scheme at that date will retain their existing level of tax savings until such time as they leave the scheme or are no longer eligible to participate.

The changes do not affect workplace nurseries.

Capital allowance changes

The draft Finance Bill 2011, released on 9 December 2010, contains several amendments to the capital allowances regime. The changes, first announced at the 2010 Emergency Budget, will take effect from April 2012 and include reductions to:

- the rate of writing down allowances (WDAs) from 20% to 18% for all assets other than those in the special rate pool
- the rate of WDAs for assets in the special rate pool (eg integral features, long life assets and cars acquired after 1 April 2009 with carbon emissions of more than 160g/km), from 10% to 8%

- the Annual Investment Allowance, which broadly entitles businesses to claim 100% of the cost of qualifying plant and machinery (except for cars) as a deduction from their profits, from £100,000 to £25,000

Although these changes only defer the tax relief available, it may prove to be an incentive for businesses to accelerate their planned capital expenditure, in order to take advantage of the current higher rates.

Corporate tax rate changes

The draft Finance Bill 2011 also includes several clauses in respect of corporation tax rate changes. As announced at the 2010 Emergency Budget, the draft Finance Bill 2011 includes a reduction to the:

- main rate of corporation tax from 27% (from April 2011) to 26% from April 2012.
- small companies' rate of corporation tax from 21% to 20% from April 2011.

While the changes are not new news, it should be noted that when the Finance Bill has been passed by the House of Commons (likely to be sometime in the summer of 2011), any deferred tax assets or liabilities recognised in financial statements signed after this date should be recognised at these lower tax rates.

Associated companies

The availability of the small companies' rate of corporation tax is dependent on the number of associated companies that a company has. The draft Finance Bill 2011 introduces provisions to simplify the definition of an associated company for these purposes from April 2011 onwards.

The legislation extends the current exemption available for companies linked by partners, to include all associates of participators, where there is substantial commercial interdependence between the companies.

The revised draft legislation defines what is meant by substantial commercial interdependence by considering the degree to which two companies are:

- financially interdependent
- economically interdependent
- organisationally interdependent

Whilst the simplification of the associated company test is welcome, much of the detail is contained in HMRC guidance which has no statutory force and, therefore, may create more uncertainty.

Increase to the Bank Levy rate

The draft Finance Bill 2011 includes provisions to increase the rate of the Bank Levy. It was originally announced, at the 2010 Emergency Budget, that the rate of the levy would be 0.04 in 2011 and 0.07% from 2012 onwards. These rates are now set to be increased to 0.05% and 0.075% respectively. Whilst the percentage change may appear small, given that the levy is applies to liabilities over £20 billion, the actual increase in the tax take may be quite significant.

The Bank Levy is a tax on the balance sheet liabilities of banking groups and building societies and is intended to encourage banks to move to less risky funding profiles and to ensure that they make a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy.

New lease accounting standard kept on a short leash

The Government has announced changes to mitigate the tax implications for companies adopting the proposed new lease accounting standards under international financial reporting standards and the financial reporting standard for medium-sized enterprises (proposed to replace current UK generally accepted accounting practice from 2013).

The draft Finance Bill 2011, contains provisions which will mean that the definition of leases in the accounting standards in force immediately before 1 January 2011 will continue to be used for tax purposes. This will be the case where those definitions change after that time, and a company accounts for its leases under a new accounting standard.

The proposed measure will maintain tax certainty for businesses and Government alike, by ensuring that the tax treatment of any leases will continue as if any accounting change had not taken place. Therefore, following the adoption of the new lease accounting standards, the current tax deductions, allowances, and anti-avoidance legislation should continue to operate.

However, this will have a cost as businesses will need to maintain two sets of lease records (one for accounting purposes and one for tax purposes). Therefore, it is hoped that the Government will not rely on this provision as a long term solution for the taxation of leases.

Simplification of corporate gains

Following a consultation earlier this year, HM Revenue & Customs has released details of the final provisions which are intended to be introduced into the Finance Bill 2011 in order to simplify the taxation of capital gains for companies. The changes cover three of the main anti-avoidance provisions contained in the capital gains legislation for groups of companies.

Degrouping charges

The most significant changes are in respect to degrouping charges, which arise when a company leaves a capital gains group with an asset which has been transferred to it from another group company on a 'no-gain no-loss' basis, within a six year window.

Where the shares in a company are sold, and a degrouping charge arises, the new provisions will deem the charge to be additional consideration for the shares, which will therefore exempt the charge from tax where the disposal of the shares qualifies for the substantial shareholding exemption. There will also be new provisions to reduce the amount of the degrouping charge on a 'just and reasonable' basis in certain cases where the amount is effectively also subject to tax as part of the corporate gain on the disposal of the shares. Some further changes will also be made to the substantial shareholding provisions to facilitate the disposal of the 'trade and assets' of a businesses.

This will represent a significant simplification. However, it should be noted that where the asset concerned is UK property, the degrouping provisions in the Stamp Duty Land Tax regime may still apply.

Value shifting

The second set of changes simplify the 'value shifting' provisions, which apply where the value of the asset is reduced in order to generate a tax advantage. The current complex provisions will be amended to produce a more targeted purpose test, aimed at tax avoidance arrangements. It will introduce a six year time period, whereby transactions would not fall within the provisions where there is a period of at least six years between the reduction in the value of the asset and the crystallisation of the corporate gain or loss.

Capital losses on the change of ownership

The last of these changes is to the treatment of capital losses within a company where there is a change of ownership. These provisions will be relaxed slightly, so that there will no longer be any restriction in respect of capital losses crystallising after the change in ownership. In addition, losses existing in a company before a change in ownership will be able to be used against a wider range of assets than the current anti-avoidance provisions allow.

Contributed by Francesca Lagerberg

Lecture P631 (8.56 Minutes)

Personal Tax

Universal credit

A Government white paper was issued in November 2010 setting out plans for the new benefit system, to be called “Universal credit”. The new system is subtitled “Welfare that works” and will replace almost all social security benefits and tax credits from 2014. It will be introduced for new claimants from late 2013.

Although strictly a pure welfare benefit system, there is some cross over with an accountant’s natural territory, as many advisers currently support clients with their tax credit claims, and information for the new benefit system will be collected from employer payroll data, so there are two aspects of the planned system that will impact on an accountant’s daily work :

- Dealing with self employed clients who may have a present entitlement to tax credits and advising them how that will change over the period 2013 – 2014, and
- Ensuring that employer clients are conversant with their new responsibilities as regards reporting data to HMRC.

In fact the latter of these is something that has already been decided – it was announced recently that the plans to require employers to provide real time information to HMRC at the point of payment of salaries is to be introduced. This aspect of the developments in the PAYE system is absolutely essential in order for the new universal credit to work.

Summary of the new benefit proposals

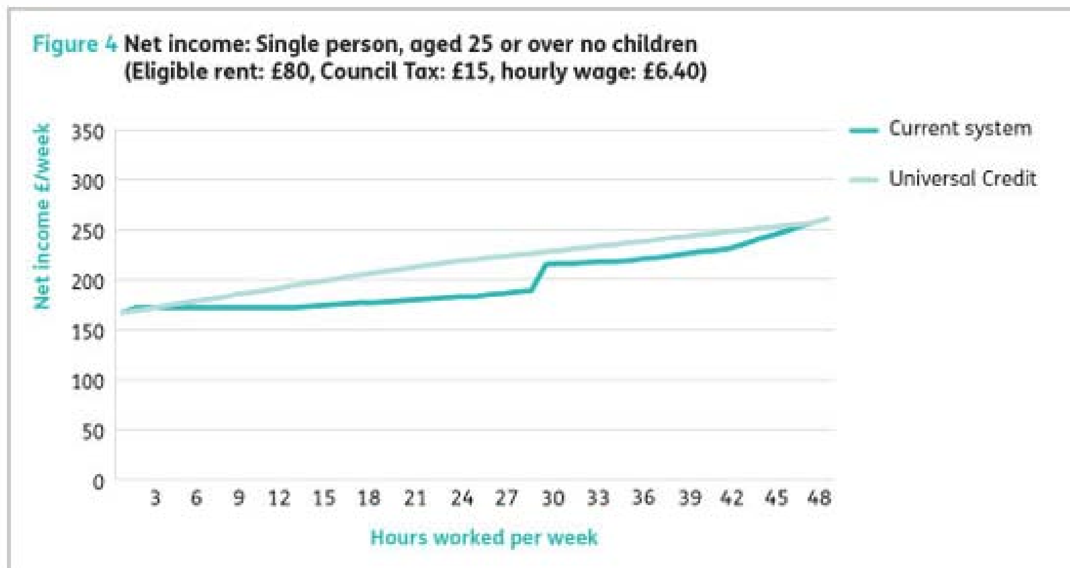
- The new single credit will replace Job seekers allowance, income support, Employment and support allowance, housing benefit (but not council tax benefit, which will be separately reformed), and both child and working tax credits. Some other benefits will also be merged into the new system.
- It will thus bring together different forms of income-related support and provide a simple, integrated, benefit for people in or out of work.
- It will consist of a basic personal amount (similar to the current Jobseeker’s Allowance) with additional amounts for disability, caring responsibilities, housing costs and children.
- As earnings rise, Universal Credit will be withdrawn at a constant rate of around 65 pence for each pound of net earnings. Higher earnings disregards (thresholds below which taper will not apply) will also reinforce work incentives for selected groups.

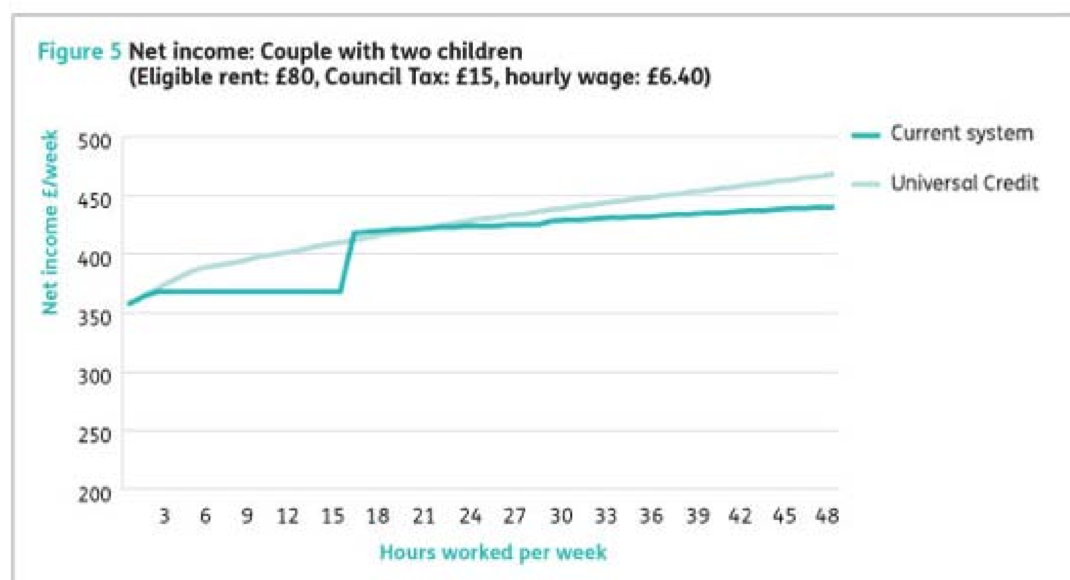
Although for current tax credit recipients 65% may seem like a very high rate of taper compared to the current 39%, rising to 41% in April 2011, when a household is in receipt of other benefits, the rate of withdrawal of benefit can presently reach in excess of 90%, and rates of 85% are common, so the new rate represents quite a change. The current rates of withdrawal apply because each benefit currently awarded is reduced at the same time for different income levels, producing a multiple withdrawal and thus very high rates of taper. Of course when the earnings are also subject to tax and national insurance contributions, the rate of withdrawal will rise, but the new structure proposes :

- A rate of 65 per cent for those earning above the income threshold but below the tax threshold (no mention is made of NIC which has a lower threshold), and
- A total rate of around 76 per cent for basic rate taxpayers (which one assumes reflects NI contributions payable by the employee).

There is, however, an important transitional protection for those entitled to benefits at the date of introduction of the new system. There is a guarantee that claimants with entitlement under the present system of benefits will be no worse off in cash terms after the change has been implemented that they were before. Given the much higher rate of withdrawal of universal credit than tax credits it is thus very important to ensure that any claimants who can claim before April 2013 do so, to establish a starting point under the old system.

The consultation provides the following graph of likely entitlement comparing systems :





The self employed

One of the major differences between the current benefit and tax credit system and the proposed new system is that the proposals are to assume a level of income for the self employed. This is likely to be around the rate of national minimum wage, so substantial capital allowance claims taking a business into loss, or the actual incidence of losses will be completely ignored under universal credit; the income will be deemed to be around £6.40 per hour minimum. This is merely a "floor" to income – higher levels of income would obviously be recognised through the new system.

Clearly, planning ideas will emerge as the new system comes closer, but it is clear at present that "lumpy income" which is a significant advantage under the current tax credit system is likely to be a disadvantage under the new system. It is not presently clear how Universal credit will be administered for the self employed as there will of course be no data feed from HMRC as to income.

Data from payroll

A large part of the administration of the new system relies on information from HMRC being passed to DWP to calculate the benefits "live". This is absolutely essential to the administration and will not produce the cost savings that Government is looking for if it cannot be achieved.

Employers will be required to provide information about pay of all of their employees electronically to HMRC in order to provide the data for this feed into DWP. It will be clear that the taper of the new award is based on net income and not gross income so the net pay information provided to HMRC will enable DWP to calculate the available credit for a taxpayer.

It was confirmed in the Autumn of 2010 that the proposals for requiring employers to provide Real Time Information to HMRC would go ahead, and software providers will be working with HMRC to design the relevant systems during 2011. The chosen communication channel is the BACS system – about which there is considerable concern, but the announcement, when made, did provide a saving for smaller employers by allowing them to submit the required data through the Government Gateway similar to current online filing requirements.

You will need to be aware of this development as it could pose problems for very small employers. As currently proposed, the requirement will be mandatory for all with no size related exceptions.

Contributed by Rebecca Benneyworth

Lecture P632 (9.45 Minutes)

Chilcott and ors v Revenue and Customs Comrs [2010]

The first and second taxpayers (C and G) were employed by the third taxpayer (E). C and G were granted exercise options over shares in E's group of companies. C and G exercised their share options in June and December 2001 pursuant to which they made substantial unrealised gains which were chargeable to income tax under Sch E by virtue of s 135 of the Income and Corporation Taxes Act 1988 (the 1988 Act). E was unable to operate Pay As You Earn (PAYE) on the notional gains received by C and G since E was not making a payment of money to them and, under s 203J of the 1988 Act, E was required to account for the balance of the tax due.

C and G did not, in accordance with s 144A of the 1988 Act, within 30 days of the exercise of their share options, make any payments to E in respect of the tax due on the notional gains. In April 2003, C submitted his 2001–02 self assessment tax return and declared taxable income received from the exercise of his share options. He subsequently paid the tax due. The Revenue opened an enquiry into C's tax return and issued a closure notice amending his tax return to charge the tax arising under s 144A of the 1988 Act, resulting in additional tax being due. In January 2003, G submitted his 2001-02 tax return and did not declare the taxable income he had received from exercising his share options. He did declare the income in May 2003 and subsequently paid the tax due on the notional gains. The Revenue issued a discovery notice in relation to G which resulted in additional tax being due under s 144A. C and G appealed the additional tax assessments. Their appeals were dismissed by the Special Commissioners. C and G appealed to the High Court. The appeal was dismissed as the judge held that s 144A was clear and free from ambiguity and that, if the submission of C and G were to be accepted, it would require that s 144A(1)(c) be ignored. C and G appealed.

They submitted that s 144A should be given a purposive construction as the section was concerned to prevent tax avoidance and/or tax leakage, which was not relevant in the instant case as C and G had paid the tax due, albeit not within the 30 day period specified. They further argued that, according to the contention of the Revenue, the terms of s 144A was to impose income tax upon them regarding the notional gain as though it was an emolument, but it was an emolument that they did not receive or, if they had received it, they did not retain it and, consequently, the section should not be read to apply to them.

Neither the judge nor the Special Commissioner had erred in their approach. Section 144A of the 1988 Act was clear and unambiguous in its terms. To require deletion of the 30 day repayment period was not permissible as a date by which repayment was to be made had to be specified. Some of its terms dealt with anti-avoidance and others dealt with the practicalities of tax collection. Such a provision was understandable as its purpose was to encourage an employee to make prompt repayment to its employer.

Grogan v Revenue and Customs Comrs [2010]

Section 703 of the Income and Corporation Taxes Act 1988, so far as material, provided: "(1) Where — (a) in any such circumstances as are mentioned in s 704, and (b) in consequence of a transaction in securities or of the combined effect of two or more such transactions, a [company] is in a position to obtain, or has obtained, a [corporation tax] advantage, then unless [it] shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable [corporation tax] advantages to be obtained, this section shall apply to [it] in respect of that transaction or those transactions. ... (3) Where this section applies to a [company] in respect of any transaction or transactions, the [corporation tax advantage] obtained or obtainable by [it] in consequence thereof shall be counteracted by such of the following adjustments, that is to say an assessment, the nullifying of a right to repayment or the requiring of the return of a repayment already made . . ., or the computation or recomputation of profits or gains, or [liability to corporation tax], on such basis as the Board may specify by notice served on [it] as being requisite for counteracting the [corporation tax advantage] so obtained or obtainable ...".

Paragraph 129(1) of Sch 2 to the Income Tax Act 2007 provides: "Despite anything in this Act, Chapter 1 of Part 17 of ICTA (cancellation of tax advantages from certain transactions in securities) continues to apply so far as required for the purposes of notices under section 703(3) of that Act requiring adjustments to be made affecting tax years before the tax year 2007–08; and a counteraction notice under Chapter 1 of Part 13 (transactions in securities) may not require such an adjustment to be made".

The taxpayer was the director and, at all material times, the sole shareholder, in a company which operated car dealerships (the company). In March 2003, his advisers informed him that he could obtain full corporation tax relief for contributions made by the company to a "qualifying employee share ownership trust" (the QUEST), but that such relief would only be available until the end of the accounting period ended 30 December 2003, when less favourable rules were due to enter into force. The advisers made it clear that their fees in relation to the implementation of that advice were entirely contingent on the tax savings obtained. Accordingly, in December 2003, the taxpayer established the QUEST. Participators in the company were excluded from any benefit from the QUEST and any new employees were excluded from any benefit for a period of five years. In December 2003, the taxpayer also sold 18.4% of the total issued shares in the company to the QUEST for £630,000. The purchase price was funded by a contribution of £633,150 in cash by the company itself (the cash transfer). At the same time, a third party offered to acquire the company's sole remaining business (the Audi franchise) for £450,000. That sale was completed in January 2004. The taxpayer paid £57,929.20 of capital gains tax in respect of the sale of shares to the QUEST. In July 2007, the respondent Revenue and Customs Commissioners purported to serve a notice on the taxpayer pursuant to s 703(3) of the Income and Corporation Taxes Act 1988 (the ICTA 1988) effectively seeking to counteract the tax advantage which it contended the taxpayer had obtained by the sale of shares to the QUEST under the provisions for the cancellation of corporation tax advantages from "certain transactions in securities". The taxpayer appealed to the First-tier Tribunal (the tribunal) (see [2010] SFTD 115). He submitted first of all that the notice should have been served under the relevant provisions of the Income Tax Act 2007 (the ITA 2007) rather than s 703 of the ICTA 1988, since the latter had effectively been repealed for income tax purposes from 6 April 2007, and the transitional provisions in para 129(1) of Sch 2 to the ITA 2007 did not apply to a notice served after 5 April 2007 in respect of a prior year. The Revenue submitted that the first notice was valid but, in any event, served an alternative notice (the second notice) under the new provisions. The taxpayer appealed against the second notice, contending that the real reason for establishing the QUEST had not been to benefit from a tax saving. The tribunal found, inter alia, that the first notice was invalid, but that the second took effect. In respect of the substantive matter, the tribunal found that the taxpayer had obtained a tax advantage, namely, the receipt by him of the purchase price of the shares as capital so that he did not pay income tax thereon. Accordingly, the tribunal held that the taxpayer had failed to establish that the provisions for the cancellation of tax advantages from transactions in securities did not apply and was therefore liable for income tax on the share sale. The taxpayer appealed. The Revenue cross appealed.

On the cross appeal, the issue which fell to be considered was whether the Revenue had been correct to serve the first notice under the ICTA 1988 rather than the ITA 2007 and, accordingly, whether the

first notice was valid. The taxpayer contended that the reference to "notices" in para 129(1) of Sch 2 to the ITA 2007 was a reference to notices given before the commencement date of the ITA 2007 (namely, 6 April 2007). The Revenue contended, however, that para 129(1) of Sch 2 to the ITA 2007 encompassed the service of notices where the tax advantage and the relevant transactions pre-dated the tax year 2007–08. In the appeal, the taxpayer reiterated that no tax advantage had been obtained "in consequence of" the securities transaction, within the meaning of the legislative provisions. He submitted that there was an implicit requirement in the legislation requiring the Revenue to establish that the receipt by him of the purchase price of the shares could have occurred in another manner so as to be charged for tax, but that the Revenue could not, after taking into account the existence of the QUEST, postulate such an alternative transaction (see [68]–[70] of the judgment). The taxpayer further submitted that in any event, the provisions could not apply to the situation where an express statutory scheme (namely the QUEST scheme) had been utilised and complied with; that the use of the QUEST was not tax avoidance or "the obtaining of a tax advantage"; or that the transfer by the company to the QUEST was not a circumstance to which s 704D(1) of the ICTA 1988 or s 689(2)(a) of the ITA 2007 applied (see [53]–[54], [62]–[63] of the judgment).

(1) For the purposes of para 129(1) of Sch 2 to the ITA 2007, it was at the very least well arguable that action could be taken which "affected" years which were later than the year to which the tax advantage related. It was also well arguable (and the instant tribunal was inclined to the view that the following was correct) that all of the years "affected" had to be prior to 2007–08. However, the question whether a notice should be served under the old or the new provisions when affected years included both a year before 2007-08 and that year or a later year would be left open (see [46]–[47] of the judgment).

If the draftsman had intended that the transitional provision in para 129(1) of Sch 2 to the ITA 2007 was to apply only in cases where a notice had already been served, it would have been easy for that to have been stated clearly using words such as "...continue to apply for the purposes of notices under s 703(3) served before 6 April 2007". It would have been altogether unnecessary to refer to adjustments at all. Instead, the qualification placed on notices which fell within para 129(1) was that they were ones "requiring adjustments to be made affecting tax years before the tax year 2007–08". There was nothing in the wording of that qualification which supported the conclusion that the notice itself had to be served before the start of that tax year (see [29]–[30] of the judgment).

The instant case was within para 129(1) of Sch 2 to the ITA 2007 (see [47] of the judgment).

The first notice was valid (see [47] of the judgment).

(2) A tax advantage could be obtained "in consequence of" a transaction in securities notwithstanding (a) that another operation, which was not a transaction in securities, was a necessary ingredient and (b) that such other operation was not one which took place "in consequence of" the transaction in securities. There was no reason in principle why the other operation had to take place after the transaction in securities itself. It was enough if the tax advantage was obtained as the result of an overall series of transactions which were linked together to form a scheme and where the relevant transaction in securities was part of that scheme (see [119] of the judgment).

In the instant case, the taxpayer had obtained a tax advantage in consequence of a transaction in securities (see [120] of the judgment).

Peter Gamble

The taxpayer was employed as a sales executive at different times with different employers. His place of work in each case was his home, but he was sometimes required to attend the company's office and had to visit customers both in the UK and abroad.

He was provided with a laptop, but used his own mobile phone and home office equipment, including a personal computer, fax and printer.

In his 2005/06 tax return, the taxpayer claimed more than £17,200 as allowable expenses. HMRC disputed the claim, so the taxpayer appealed.

The First-tier Tribunal found that in respect of the expenses claimed in respect of his London room rent, phone and internet, palm computer and fixed phone expenses, the taxpayer was not entitled a deduction because the expenses had not been incurred under ITEPA 2003, s 336(1).

Similarly, his Wiltshire home, phone and internet, office costs, and magazine subscription did not fall under the exemption. The expenses put the taxpayer in a position to perform his duties of employment, but were not incurred in the performance of the duties of employment.

The tribunal concluded that the appellant was not entitled to any of the deductions claimed on his 2005/06 tax return, other than the travel expenses previously accepted by HMRC.

The taxpayer's appeal was dismissed.

Restriction of pension's tax relief—Carry forward and input periods

HMRC has published further guidance on two aspects of the legislation on the reduced pensions annual allowance: the carry-forward provisions and pension input periods.

On 14 October 2010 HM Revenue & Customs (HMRC) published draft legislation covering the reduced annual allowance. Together with draft guidance to help individuals and the pension industry to understand the changes and to give all interested parties as much time as possible to comment on the draft legislation and to prepare for the new regime. As HMRC have received a number of queries and comments on the legislation and guidance, HMRC thought it would be helpful to provide further clarification on some of the issues raised.

Carry forward provisions

The provisions covering the carry forward of unused annual allowance have attracted a number of queries particularly around who can take advantage of it and how the amount of unused annual allowance available for carry forward from the years 2008–09, 2009–10 and 2010–11 should be calculated.

Do I need to have made pension savings for a tax year if it is to qualify for carry forward?

An individual can carry forward unused annual allowance from any year during which they were a member of a registered pension scheme, regardless of whether they made any contributions during that year or had a nil pension input amount during that year.

What rules apply for pre 2011–12 carry forward?

The amount of any unused annual allowance for the years 2008–09, 2009–10 and 2010–11 should be calculated by applying the rules that would apply if the pension input period for each of those years were a pension input period ending in the tax year 2011–12 and using an assumed annual allowance of £50,000 for each of those years. The CPI can be found on the website of the Office for National Statistics at www.statistics.gov.uk/downloads/theme_economy/CPI.pdf. The CPI up-rating factors to use for each of these years is:

- September 2007 (for use for 2008–09) 1.8
- September 2008 (for use for 2009–10) 5.2
- September 2009 (for use for 2010–11) 1.1
- September 2010 (for use for 2011–12) 3.1

What happens if my pension savings are £40,000 for 2008–09, £70,000 for 2009–10 and £40,000 for 2010–11?

For years 2008–09 and 2009–10, you can only carry forward unused annual allowance to 2011–12 if it has not been used up in a subsequent year. For example, Sarah has pension input amounts of £40,000 in 2008–09, £70,000 in 2009–10 and £40,000 in 2010–11. She has £10,000 unused annual allowance to carry forward to 2011-12, as although her pension input amount was less than £50,000 in 2008–09, this would have been used up in full in 2009–10 as her pension input amount for that year was more than £10,000 greater than £50,000.

HMRC will be updating guidance shortly to reflect these points.

Pension input periods

HMRC have also received a number of queries around how schemes can align their pension input period to the tax year if they wish to do so. Some schemes may want to do this to make it easier for their members to work out their pension savings for the tax year.

Input period absent nomination

Under the annual allowance provisions, the first pension input period of an arrangement ends on the anniversary of the commencement date of that pension input period unless the scheme (or the individual in the case of a money purchase arrangement other than a cash balance arrangement) nominates otherwise. A scheme can only have one pension input period in each income tax year and each pension input period must not exceed 12 months. Therefore, following the introduction of the annual allowance charge on 6 April 2006, any scheme that did not nominate to change their pension input period to an alternative date in their first year will have a first pension input period ending on 6 April 2007 and will have pension input periods ending on 6 April going forward.

What if the scheme has not yet nominated?

It would seem that some scheme administrators did not realise that this was the case and thought that if they had not nominated for an alternative end date for their first pension input period, the default was to the tax year, so that their pension input period runs to the 5 April each year. Having realised that this is not so, they are now looking to change their pension input period so that it does align with the income tax year. The nomination rules mean that a scheme can bring forward the end date of pension input period to a date earlier in the tax year

Retrospective nominations

Under the current legislation a scheme can, where no previous nomination has been made, make a retrospective nomination to unwind their pension input period back to the first pension input period. By retrospectively nominating for their first pension period to end on 5 April 2007, the scheme can align their pension input period to the income tax year for all subsequent periods. Once you have made a nomination to change the PIP then you can't make a second nomination for the same tax year.

Consequences for schemes and individuals of retrospective nominations

Changing the scheme's pension input period in this way may have an impact on a member's tax liability, as it may result in a member's contributions or benefit accrual falling within a different tax year for the purposes of the annual allowance charge. If the scheme has always worked on the basis that their pension input period ended on the 5 April this is likely to have little if any effect and is only likely to affect members who have made large contributions close to the end or beginning of the income tax year. However, it is worth noting that members will be liable to any annual allowance charge that arises as a result of the change in the pension input period and will be able to claim any repayment of any overpayment that may arise as a result of the change. A repayment claim can be made up to four years after the end of the tax year in which the overpayment arises.

How to make a retrospective nomination

The scheme must advise their members if they nominate for their first pension input period to end other than on the scheme anniversary. If a scheme does not do so, that member's pension input period automatically defaults to the anniversary of the date they joined the scheme or 6 April if the member joined the scheme before 6 April 2006.

If a scheme wishes to retrospectively nominate for their first pension input period to end on 5 April 2007, they need to do so before the draft legislation receives Royal Assent. Under the draft legislation, from 6 April 2011 it will not be possible for a nominated date to be a date before the date on which the nomination is made.

Annuitisation rules from 6 April 2011

The exact changes from 6 April 2011 are now clearer. Flexibility is the main result, with no compulsion to purchase an annuity. This is good news, especially given the government announcement in December 2010 that nearly 1 in 5 people in the UK will reach their 100th birthday – something which is bound to reduce annuity rates even further.

From 6 April 2011 the requirement to secure a pension income by age 75 (or 77 if not 75 before 22 June 2010) is being removed through a number of changes as explained below. Naturally all income withdrawals are subject to income tax, and careful planning may serve to reduce the tax burden.

1. The assured secure pension (ASP) rules are being repealed for new and existing pensioners, so removing the effective requirement for pension savers to buy an annuity by the age of 75 or 77.
2. The maximum income that an individual may withdraw from most drawdown pension funds will be capped at 100% of the equivalent single-life annuity instead of the current 120%, but it will apply for as long as an individual retains the fund.
3. The minimum annual withdrawal amount from age 75 or 77 will be abolished – this is currently 55%.
4. The maximum capped amount that may be withdrawn will be determined at least every three years until the end of the year in which the member reaches the age of 75, after which reviews will be carried out annually.
5. Individuals with drawdown pensions who have a secure lifetime pension income of at least £20,000 a year will be able to access the whole of their drawdown funds as pension income without a limit on annual withdrawal - subject to their provider offering flexible drawdown pensions.
6. For the £20,000 test, lifetime pension income is defined as *relevant income* being income from any of the following:
    - payments of a scheme pension or dependants' scheme pension provided by a registered pension scheme
    - payments of a lifetime annuity or dependants' annuity made by a registered pension scheme
    - payments under an overseas pension scheme which, if the scheme was a relevant non-UK scheme, would fall within the above
    - payments of a social security pension (this includes a non-UK source pension of a similar character)
7. Relevant income excludes any of the following:
    - a drawdown pension or dependants' drawdown pension
    - any payments under an overseas pension scheme which, if the scheme was a relevant non-UK scheme, would fall within the above
8. Any new pension savings for an individual once a scheme has accepted an application to access the whole of their drawdown pension fund will be liable to the annual allowance charge on all pension input amounts
9. An individual making a withdrawal from a flexible drawdown pension fund during a period when they are resident outside the UK for a period of less than five full tax years will be liable to UK income tax on that withdrawal for the tax year in which they become UK resident again.
10. Most of the rules preventing registered pension schemes from paying lump sum benefits after the member has reached the age of 75 are being removed.
11. The tax rate for all lump sum death benefits is to be set at 55%, apart from death benefits for those who die before age 75 without having taken a pension, which will remain tax free.
12. Unused drawdown pension funds of a member who dies with no living dependants may be donated tax free to a charity.

The above changes will also apply to members of non-UK pension schemes who have received either tax relief on contributions or had funds transferred from registered pension schemes.

The inheritance tax (IHT) changes proposed can now be detailed as follows, all from 6 April 2011:

- IHT will not typically apply to drawdown pension funds remaining under a registered pension scheme, including when the individual dies after reaching the age of 75 or 77
- IHT anti-avoidance charges that apply to registered pension schemes and Qualifying Non-UK Pension (QNUP) Schemes where the scheme member omits to take their retirement entitlements (e.g. a failure to buy an annuity) will be removed
- IHT charges that may arise where pension scheme trustees have no discretion with regards to the paying out of lump sums after the death of scheme members (i.e. where amounts must be paid to their estate) will remain subject to IHT
- IHT will continue to apply to all other lump sums (i.e. those in a non-Registered Pension Scheme or non-QNUP)

Contributed by Gerry Hart

Lecture P634 (10.26 Minutes)

Stephen Joyce

The taxpayers were directors of Vickers, a wholly owned subsidiary of Rolls-Royce. The latter wished to dispose of its subsidiary and, after the intervention of some venture capitalists, managed to do so in 2005.

As part of the deal, the taxpayers would cease to be employed by Rolls-Royce or any of its subsidiaries, but become directors of the merged business. In addition they would be paid a bonus and have to acquire shares in the business. They paid for the shares by cheque after they had received their bonuses.

The taxpayers claimed that the Vickers' business was effectively merged with the venture capitalists, and they believed that they were required to acquire shares in what was a new company.

However, the new company subsequently went into administration and the shares became valueless.

The taxpayers claimed relief in respect of shares that had negligible value. HMRC refused their claims, so the taxpayers appealed.

The First-tier Tribunal said that to secure relief the taxpayers had to show that TA 1988, s 574(1) was satisfied: relief could only be given to a subscriber. Although the taxpayers believed that they had subscribed for the shares, the information in the draft accounts did not match the number or value they had each acquired.

The tribunal expressed sympathy for the taxpayers, but said the conditions in s 574 were strict.

The taxpayers' appeals were dismissed.

Westworth Ltd

In an appeal concerning the cancellation of a company gross payment status within the construction industry scheme (CIS), the appellant appealed against a review made by HMRC for the year ended December 2008.

The appellant company, a ground-work contractor in the construction industry, which was established in October 1998, made 12 late payments under the PAYE scheme during the period in question and subsequently could not be treated as having satisfied the compliance test under Income Tax (Construction Industry Scheme) Regulations 2005, reg 32.

The issue was whether or not the appellant had a reasonable excuse for its late PAYE payments. The First-tier Tribunal found that not only had the company placed a 'continuing reliance' on its consultant (who was ultimately the real cause of the late payments), but also its lack of 'experience and expertise in accounting, administrative and taxation matters' amounted to a reasonable excuse.

Furthermore, the tribunal found the imposition of a time factor – the ability to recover from a specific event within a period of time – inappropriate. It decided that the appellant company had satisfied the compliance test.

The appellant company's appeal was allowed.

Capital Taxes

Tax treatment of OEIC investment

This article examines the tax treatment of investment in collective investment schemes such as unit trusts and open ended investment companies (OEICs), and reviews the difference in tax treatment of investment using different intermediate vehicles such as:

- portfolio management;
- OEICs;
- ISAs;
- life insurance policies which invest in OEICs.
- Tax treatment of unit trusts

Unit trusts

Units in authorised unit trusts are chargeable assets and are treated as if they were quoted shares. This means that costs of acquisitions are pooled and disposals are taken out of the pool at average cost. This is now a relatively simple process which can be easily derived from the statements provided by fund managers; before 6 April 2008, when individual acquisitions had to be identified separately, it was a time-consuming and complex calculation to deal with something that usually only produced small gains.

Note that unit trusts are valued only on the bid price, not on "quarter up" (if they are still quoted on a bid/offer spread). *s.272(5) TCGA 1992*

Equalisation

When a person invests in units during the trust's income period, the units are effectively bought "cum dividend" – the investor will receive the whole of the next income distribution, even though some of it will have arisen before the acquisition.

An adjustment called "equalisation" is made to reflect this. It applies only in the year in which units are acquired (these are called "Group 2 units" to distinguish them from units held throughout the trust's income period). The trust declares how much of the distribution to Group 2 units is to be regarded as equalisation; this is then:

- not treated as taxable income of the recipient;
- deducted from the base cost of the units for CGT.

This means that the amount paid for accrued income is treated as "returned" to the unitholder when the distribution is paid, so the amount paid for the units is reduced by that return of the price (rather than treating that part of the cash as income and leaving the base cost as it was).

Unitholders do not have to calculate this. A single, average figure is given by the trust for all Group 2 units. Someone investing early in the income period will appear to receive more "equalisation" than they should; someone investing at the end of the period probably receives too little.

Accumulation and income units

Income units are like ordinary shares – they pay out distributions each year which are clearly income and charged to income tax. The CGT base cost is unaffected.

Accumulation units do not pay out distributions to shareholders, but reinvest the money in the scheme. The value of units goes up, but the number of units does not change.

This is taxed in a similar way to a scrip dividend:

- the cash equivalent (announced by the unit trust) is assessed on the unitholder as income, with a tax credit;
- that net cash equivalent (ignoring any income tax consequences for the unitholder) is added to the base cost of the existing units for CGT purposes (even though the number of units is unaffected).

The date on which the expenditure is "incurred" by accumulation was important for both indexation and taper relief, but it is not important now – another major simplification from April 2008 onwards.

Umbrella schemes

It may be possible for a unitholder to switch between different funds of the same manager. This is likely to be treated as a disposal and acquisition for CGT purposes. There will be no deferral of the gain, so a charge will arise (or the transaction could be used for bed and breakfasting).

Monthly savings plans

Identification rules apply to unit trusts as for other shares. Where an investor subscribed to a monthly savings plan which was not within an exempt vehicle, the result was horrendous: a succession of individual acquisitions that had to be separately identified, indexed and tapered. Fortunately such computations are now consigned to the past: it should be very easy to work out the average cost of the current holding on such plans (although they could be complicated where there were earlier disposals under the old rules).

Practical example – from the files

The following table sets out the records of an investment holding with details of equalisation and accumulations. The notes explain the application of the above rules and principles to these figures.

Name	Units		Bought	Cost	Equal	Acc inc	Net cost
Fid FIF European	1,535.53	A	29/05/07	20,000.00	90.37	0.00	19,909.63
First State Asia Pacific Leaders	4,885.20	A	29/05/07	10,000.00	29.44	151.26	10,151.26
Gartmore UK Equity Income Fund Inc	7,264.80	I	29/05/07	20,000.00	127.94		19,872.06
Fid FIF Global Property Fund Acc	8,980.37	A	29/05/07	10,000.00	11.41	134.71	10,134.71
Schroder European Alpha Plus Fund Inc	18,939.39	I	12/02/07	20,000.00	79.97		19,920.03
Schroder Gilt and Fixed Interest Fund Inc	90,041.42	I	12/02/07	50,000.00	635.88		49,364.12
JOHCM UK Opportunities Fund Acc	14,624.78	A	20/11/08	14,221.59	380.99	206.09	14,427.68
JOHCM UK Opportunities Fund Inc	15,348.78	I	27/05/09	switch	227.44		14,200.24
Legal & General Fixed Interest Tst A Inc	104,755.51	I	10/02/09	51,539.71	477.53		51,062.18
Neptune Income Inc	11,641.44	I	12/02/07	20,000.00	177.56		19,822.44
INVESCO PERPETUAL Income Inc	1,373.63	I	29/05/07	20,000.00	166.28		19,833.72
Schroder Recover Fund Inc	311.14	I	12/02/07	20,000.00	126.51		19,873.49
JPM Japan A Acc	6,890.22	A	12/02/07	15,000.00		0.00	15,000.00
UBS US Equity Fund	13,044.61	A	12/02/07	10,000.00		39.13	10,039.13

Sales

Fund	Units	Date	Net cost	Proceeds	Gain/loss
Schroder European Alpha Plus Fund Inc	18,939.39	19/11/08	19,920.03	14,221.59	-5,698.44
Schroder Gilt and Fixed Interest Fund Inc	90,041.42	09/02/09	49,364.12	51,539.71	2,175.59
JOHCM UK Opportunities Fund Acc	14,624.78	27/05/09	switch		

The equalisation and accumulation details are taken from documents provided by the fund manager.

On an income unit, the equalisation reduces the base cost and the income. For example, the Gartmore UK Equity units might have paid a total distribution of £250: of this, £127.94 was deducted from base cost (so increasing any future capital gain), and the remaining £122.06 would be taxable as income.

On an accumulation unit, the equalisation only reduces the taxable income; or, to look at it another way, it is deducted from base cost as a return of capital, but then added again as an accumulation. So on the JOHCM UK Opportunities accumulation units, there was a total accumulation of £587.08. Of this, £380.99 was deducted from cost but then added back again; the remaining £206.09 was taxed as income and increased the base cost.

The switch from accumulation to income units in the JOHCM UK Opportunities fund would not count as a disposal, so the base cost of the accumulation units was transferred across. However, the new units are still counted as "Group 2" by the fund manager because they have been acquired during the 2009 accounting year – so there is equalisation to deduct from the base cost as part of the distribution for that year.

ISA: technical rules

A maximum of £10,200 (rising to £10,680 from 6 April 2011) can be put into Individual Savings Accounts during each tax year. No more than half of this can be invested in a "cash ISA". It is permissible to invest the whole amount in stocks and shares. The fund manager may hold some of a stocks and shares ISA in cash temporarily, but it is supposed to be reinvested in due course.

The tax advantages for ISA investment in shares are:

- exemption from CGT on any gains;
- income tax exemption for any income arising (so no higher rate tax to pay, even for a higher rate taxpayer).

"Free shares" in building societies and mutual insurers which convert to plc status are treated by HM Revenue & Customs as having no base cost – the investor has not paid for them, as the deposit account or insurance policy in respect of which they are issued is not affected or reduced by the creation of the shareholding. Because the shares were regarded as "free", they could be added to a PEP (the predecessor of ISAs) without affecting the £6,000 PEP subscription limit for the year – provided that they were transferred within 42 days of the allocation to the shareholder. Any proceeds of sale were then protected from CGT. The rules were changed for ISAs: new issues cannot be transferred "free" into an ISA. They therefore count towards the subscription limit for the year.

Tax shelters

If you intend to invest in particular shares, you may be able to make that investment through different means which will change the tax treatment. The following notes review the different tax treatments of some common ways of investing. Although the success or failure of an investment depends much more on the investment decision than on the tax treatment, it is useful to understand that tax treatment in order to assess how well the investment suits a particular taxpayer; it is also essential to understand the tax treatment in order to assess the truthfulness of claims to tax benefits which may be made by the people selling the investments.

Common tax shelters include:

- unit trusts/OEICs: have the advantage that the manager can get on with managing the investment without you being taxable on switches – the fund is not 'transparent' for capital gains (although it is transparent for income);

- approved Venture Capital Trusts: have to invest in particular types of small company, but enjoy very significant tax reliefs, in particular the exemption of any capital gains (but also the exemption of capital losses);
- Individual Savings Accounts: a limited amount can be invested each year, but investments held within the plan are free from CGT while they remain in it;
- single premium life assurance policies: these are 'envelopes' commonly used for holding unit trusts – they change the tax treatment, because they are not transparent for income or gains, and the profit made on cashing the policy in is chargeable to higher rate income tax rather than to CGT. In addition, a cash withdrawal of up to 5% of the original sum invested can be withdrawn each year without triggering any tax charge at all.

The change in the CGT rate on 23 July 2010 alters the mathematics of the alternatives considerably, because investments which will be charged to CGT become once more significantly more favourable than those which are charged to income tax.

"School fees planning"

The use of single premium life insurance policies to pay school fees is a traditional plan which is based on the different tax treatments of different investments. It depends on someone who is a higher rate taxpayer (assumed for this purpose to have a taxable income between £37,400 and £150,000 in 2010/11, rather than over £150,000) having a lump sum currently available which is "earmarked" for paying school fees; this lump sum can be invested in various different types of fund, but will be drawn down in annual chunks over the next twenty years or so while a succession of children are put through private school and university.

Suppose the initial fund is £200,000 and the individual wants to draw £10,000 each year. The main choices are between:

- direct investment, for example in a managed portfolio of shares or cash accounts;
- open-ended investment company shares or unit trusts;
- single premium life insurance policies.

In each case, the money will be invested in the same sort of underlying assets – stock market investments. The tax treatment of the three situations is:

	Income	Capital gains
Direct	Charged to higher rates on the individual as it arises, whether drawn or not	Charged to 28% CGT on the individual as soon as any investments are switched, whether cash is drawn out or not
OEIC	Charged to higher rates on the individual as it arises, whether drawn or not	Charged to 28% CGT on the individual if units are cashed in to finance the £10,000 annual drawing
Life policy	Charged to savings rate only in the life company	Charged to savings rate only in the life company: 5% of the original sum can be drawn each year without any charge

As long as no more than 5% is drawn out of the life policy each year, there is no higher rate tax charge at all on the individual. After 20 years, the whole of the original sum has been drawn, and anything left represents the accrued income and growth in the policy over the whole period (i.e. it is "the profit"). When it is drawn, it will be chargeable to higher rate income tax (the excess of 40% or 50% over 20%), but not to CGT and not to the lower rate of income tax. It will not be charged at all if the taxpayer is not a higher rate taxpayer in the year in which the policy is encashed, taking into account the profit on encashment divided by the number of years for which the policy has been held.

Example

Arthur has held a single premium life policy for 20 years, drawing out 5% each year. At the end of the period, the value left in the policy is £150,000. He has now retired and is drawing a pension of £27,000pa, having been a higher rate taxpayer every year up to this point.

£150,000/20 = £7,500: that is not enough to make Arthur a higher rate taxpayer (unless there is significant other income as well), so he would not have any tax liability on the encashment of the policy.

Of course, it is not necessary to have children to send to school in order to use this particular plan. It only supposes that there is a lump sum now which a higher rate taxpayer wants to invest in order to produce a stream of regular relatively small cash releases over the next twenty years. It could equally be "summer holiday planning".

Pension funds

For all the bad press that pension funds have had in recent years, the tax exemption of gains is still a very significant advantage. The tax credit on dividend income is not repayable to pension funds any more, but there is still no higher rate tax on dividends, and no tax at all on other forms of income. The tax relief on entry is also very significant.

The imposition of higher rates of tax on personal income makes the income tax exemption for pension funds much more attractive. For someone who earns over £37,400 in taxable income a year, the exemption of the pension fund will be a hidden tax break of 40% on income and 28% on gains. It will be hidden because it usually does not occur to people with a pension fund that they would be paying a lot more tax if they held the assets directly.

The following example will use the upcoming NIC rates, which will be rising by 1% for both employers and employees on 6 April 2011.

Example

Employee A has salary of £100, which his employer pays to him, deducting PAYE. He invests it in stocks which produce capital growth at a compound rate of 6% and which pay dividends of 4% net per annum.

How much will he have after 5 years?

He can only invest £58 (after 40% tax and 2% NIC). The growth is reduced to an effective rate of 4.32% by the 28% CGT charges. The dividends are reduced to 3% pa by higher rate income tax.

According to my spreadsheet, he will therefore have (in very simple terms) £58 x $(1.0432)^5$ + 5 x £58 x 3%* = £82.

* the spreadsheet escalates this for increases in the capital value.

After 10 years: £58 x $(1.0432)^{10}$ + 10 x £58 x 3%* = £111.

After 15 years: £58 x $(1.0432)^{15}$ + 15 x £58 x 3%* = £147.

After 20 years: £58 x $(1.0432)^{20}$ + 20 x £58 x 3%* = £191.

After 25 years: £58 x $(1.0432)^{25}$ + 25 x £58 x 3%* = £246.

After 30 years: £58 x $(1.0432)^{30}$ + 30 x £58 x 3%* = £314.

Employee B's employer is willing to pay an equivalent amount into a pension scheme for B. Because the employer will not have to pay employer's NIC on this, the amount invested is £113.80. The pension fund invests it in stocks which produce capital growth at a compound rate of 6% and which pay dividends of 4% net per annum.

How much will he have after 5 years (and how much more than the above)?

In very simple terms: £113.80 x $(1.06)^5$ + 5 x £113.80 x 4%* = £179 (220%).

After 10 years: £113.80 x $(1.06)^{10}$ + 10 x £113.80 x 4%* = £267 (242%).

After 15 years: £113.80 x $(1.06)^{15}$ + 15 x £113.80 x 4%* = £385 (263%).

After 20 years: £113.80 x $(1.06)^{20}$ + 20 x £113.80 x 4%* = £542 (284%).

After 25 years: £113.80 x $(1.06)^{25}$ + 25 x £113.80 x 4%* = £753 (306%).

After 30 years: £113.80 x $(1.06)^{30}$ + 30 x £113.80 x 4%* = £1,035 (330%).

However, even after 30 years, you never get to the point where the tax-free lump sum (25% of the fund) is as much as the whole of the fund you would have had with non-pension favoured investment. Because annuity rates are so low, people tend to undervalue the pension that the other 75% of the fund must be used to buy.

If employee A put the money in an ISA instead of a taxable investment account, he would still only be able to invest £58. However, he would enjoy the tax free growth rates and would end up with £91, £136, £196, £276, £384 and £528 in comparison with the pension funds shown above. He would also be able to withdraw the whole of it in cash – £528 "in the hand" may seem to be worth more than 25% of £1,035 (£259) and an annuity purchased with £776.

He would also only be able to put a maximum of £10,200 into the ISA each year, whereas pension investment has much higher limits.

The significant disadvantage of the pension fund is that you cannot touch the money. It is locked away until your retirement, and then 75% of it has to be used to buy you an annuity. Even so, the tax reliefs are considerable.

The rules on pension funds are beyond the scope of this course, but here is a brief summary:

for most "ordinary taxpayers" (i.e. not very high earners, very high net worth individuals), contributions to pension funds are allowed up to 100% of earnings, with full tax relief;

there is be an overall limit on the amount which can accumulate in a tax-advantaged pension fund (currently £1.8m, although it is hard for most people to achieve that level of fund, and the limit is in any case set to fall to £1.5m again);

the tax benefits of investing in a pension fund are very generous (deduction against income on the way in, exemption for income and gains while the money is in the fund).

There are further restrictions on contributions to pension funds in 2011/12, but the proposed level – £50,000 – will not affect the great majority of ordinary taxpayers and savers.

Contributed by Mike Thexton

Lecture P633 (25.34 Minutes)

Administration

Anti-avoidance update

The end of the game of cat and mouse for loan relationships

The Government announced a number of anti-avoidance provisions in connection with the taxation of loan relationships on 6 December 2010. These announcements deal with three particular types of avoidance scheme, some of which have been around in one form or another for a number of years now.

The first two schemes rely upon the different accounting treatment available to parties of a loan relationship - in certain cases, two members of the same group can account for the same loan relationship in different ways and generate a tax advantage (ie one company receives tax relief on the payment of interest while the other company is exempt from tax on the receipt of that same interest).

Although these schemes have previously been closed by the tightening up of legislation, the reactive nature of these legislative changes has meant that there has still been scope to circumvent the revised provisions. The approach taken with the current announcements is to target these type of schemes with a more general anti-avoidance provision, preventing a tax advantage arising where a company enters such a scheme. These changes take effect from 6 December 2010.

The third scheme, which relies on the tax treatment applied to loan relationships recognised in the company's accounts in a currency other than sterling, has also been targeted by the Government. The proposed new legislation applies to UK resident investment companies and prevents any foreign exchange or loss arising in respect of such loan relationships being brought into account for tax purposes in certain circumstances. The new provisions also allow for companies to elect to use a different currency for tax purposes than the currency used in their accounts, to reduce their compliance burden. These changes come into effect for accounting periods commencing on of after 1 April 2011.

The veil is lifted on trusts

The Government announced in October 2010 that they would look to bring forward legislation to ensure that intermediary vehicles, including employee benefit trusts (EBTs), and funded employer-financed retirement benefit schemes (EFRBS), are no more attractive for tax purposes that other forms of remuneration.

Draft legislation was issued on 9 December 2010 with the new provisions taking effect from 6 April 2011. The legislation is designed to impose a charge to income tax and national insurance on the value of any amounts provided as reward or recognition in connection with the individual's employment by a third party. This new charge will apply where amounts are 'earmarked' for employees, loaned to employees or assets are transferred to employees after the commencement date.

In the meantime, anti-forestalling provisions will apply from 9 December 2010 until 5 April 2011. These provisions will ensure that any amounts provided to individuals (be it the payment of cash, the transfer of assets or the loan of cash) will be subject to a charge to income tax and national insurance. This anti-forestalling charge will not crystallise until 6 April 2012, and will be reduced where the individual returns any of the amounts provided before this date or is subject to tax on those amounts under the normal charging provisions.

Property transfers into trust inherit the DOTAS regime

From 6 April 2011, inheritance tax (IHT) arising on property transferred into a trust will join the other taxes and fall within the disclosure of tax avoidance schemes (DOTAS) regime.

The DOTAS provisions were first introduced in 2004 for income tax, corporation tax and capital gains tax and have since been extended to national insurance and stamp duty land tax. The regime requires specific persons to 'disclose' information to HMRC about tax schemes which have certain characteristics or 'hallmarks' within a specified time. The aim of the regime is to increase HMRC's knowledge of avoidance schemes being implemented, allow it to identify taxpayers who have used such schemes, and introduce targeted anti-avoidance legislation.

Although the scope of the rules has always extended to IHT, there has never been a requirement to make disclosures. Following a consultation in July 2010, HMRC has now issued disclosure requirements covering IHT, the result is that the DOTAS regime for IHT will run in a very similar manner to that for other taxes.

One major difference is that there will be no 'hallmark' test - this is because HMRC has no real knowledge of the extent of activity in this area. Instead, these provisions will apply to circumstances where property is transferred into certain trusts, where the main benefit of the arrangements is a reduction or elimination of a charge to IHT on that transfer of that property into the trust.

The provisions will include a 'grandfathering' rule to limit the number of unnecessary disclosures - this will negate the need to disclose schemes which are the same, or substantially the same, as schemes first made available for implementation before a set date. To facilitate this, HMRC has agreed to issue a list of such schemes.

The future for anti-avoidance

The idea of a general anti-avoidance rule (GAAR) for the UK has been around for a number of years, at various levels of the Government's agenda. It reappeared after the 2010 Emergency Budget and, following various informal consultations with interested parties in the summer, the Government has announced that a full review will be undertaken by Graham Aaronson QC - the focus of this review will be on whether a GAAR could be effective for the UK tax system and if so, on how this could be structured.

The aim of introducing a GAAR should be to make the UK tax system more competitive, providing taxpayers with more certainty by ensuring that what they do now will not be affected by anti-avoidance legislation introduced in the future. However it would undoubtedly bring increased complexity and uncertainty in the short term.

In an ideal world, the advantage of a GAAR would also lead to the simplification of legislation, by the removal of the vast amount of targeted anti-avoidance provisions. However, realistically, this could not happen overnight, so at least for a number of years, this would be just another anti-avoidance rule on top of all the others.

The review is planned to be completed by 31 October 2011, and if taken further, would lead to formal consultation.

Contributed by Francesca Lagerberg

Lecture P635 (9.46 Minutes)

Rincham Limited v Revenue and Customs Comrs

In June 2008 HMRC wrote to the appellant, who marketed capital redemption policies, informing it that they were considering obtaining a Special Commissioner's consent to issuing a notice pursuant to TMA 1970 s 20(8A), requesting it to deliver or make available documents relating to the policies and contracts it had issued and the latest name and addresses for its clients within 45 days. In September 2008 HMRC again wrote to the appellant (“the precursor letter”) stating that, in the absence of a response within 14 days, it would commence the proceedings for a s 20(8A) notice. In February 2009 the Special Commissioner consented to the s 20(8A) notice. The notice requested: “(1) … all policies or contracts, whether described as capital redemption policies or contracts, Endowment Trust Instruments, Growth Instruments or Deferred Annuity Certain Contracts, issued by the company to any person whether for cash, other consideration or no consideration, in the period 6 April 1998 to the date of the issue of the notice [19 February 2009]. (2) Any document that gives the name and address of any person that subscribed for any policy or held any contract (as defined in 1 above) in the period stated in 1 above. For this purpose, “any document” includes letters, including any attachments, contracts, deeds, agreements, notes of meetings, notes of telephone conversations, memoranda, faxes, telexes, emails, computer records, marketing material, planning and proposal documents …” The appellant appealed on the ground that the notice was onerous. It submitted, inter alia, that: (i) without any relevant tax liability of its own in issue, to have imposed on it such burden and trouble was not reasonable; it was “onerous” within the meaning of s 20(8B); (ii) the notice would require a very time consuming examination and review of all the files, records and papers over a 11 year period to decide whether they contained “policies or contracts … issued by the company to any person whether for cash, other consideration or no consideration”; that

the work would be for the benefit of HMRC—and connected to the potential tax liabilities of other taxpayers—not for its benefit or connected to its tax liability; (iv) its obligations extended only to documents and not to the furnishing of particulars of transactions; (v) the words "issued by the company to any person whether for cash, other consideration or no consideration" raised questions, namely whether: a particular policy or contract was in its "possession or power"; it was required to seek legal advice on whether a particular document which had been "issued" was in its "power"; and it could recall a policy/contractual document after it had been issued; (vi) the obligations in para (2) of the notice were even more onerous; (v) it was concerned that if it disclosed documents which it was not bound to deliver or make available, it might face claims for damages from the holder of the relevant policies or contracts who had complied with his/her tax obligations but had been put to trouble/expense in dealing with an HMRC investigation which it had triggered; and (vi) it was not obliged to look for any document which originated before the beginning of the six year period: s 20(8A) provides for "the giving of such a notice as is mentioned in s 20(3)"—thus the notice was a s 20(3) notice; and s 20B(5) states that a s 20(3) notice did not oblige a person to deliver or make available "any document the whole of which originates more than 6 years before the date of the notice".

The tribunal considered that where TMA1970 s 20B(5) referred to s 20(3) it meant that section alone and not that extended by s 20(8A) to unnamed taxpayers. The conditions for s 20(8A) to apply were serious, including that the failure to supply information was likely to have led to serious prejudice to the proper assessment or collection of tax. Therefore it was likely that Parliament did not intend to restrict its operation to six years. Furthermore, the presumption of regularity applied. There were five requirements for issuing the notice and whether those were satisfied was a matter for the Special Commissioner. They included requiring the appellant to deliver or make available documents originating more than six years before 19 February 2009. The requirements were not subject to the appeal. The notice made plain what was required of the appellant in complying with its terms. Lastly it was unlikely that the appellant might face claims from its clients if it complied with the notice; it would be complying with a court authorised document. If the appellant doubted the validity of the notice, it should have challenged that validity. Therefore the notice would be confirmed in its totality, save that it did not apply to documents generated to documents after the precursor letter sent in September 2008. It followed that the appeal would be dismissed; *Re an Application by Revenue and Customs Commissioners to Serve section 20 Notice* [2006] STC (SCD) 310 and [2006] STC (SCD) 376 applied.

Appeal dismissed.

Record Keeping - a problem?

During the development of HMRC's new powers, and when the tax authority was ready to start bringing forward legislation, the following was set out as the new objectives for compliance checks on taxpayers including businesses.

It is envisaged that an officer of HMRC might begin a compliance check in respect of any of the relevant taxes for one or more of a number of purposes. These include checking that:

- *a tax return, amendment to a return or claim is correct;*
- *statutory record keeping requirements are being met;*
- *tax has not been underpaid or over-claimed; or*
- *any issues concerning possible tax avoidance are considered.*

It is the second of these objectives which is currently attracting some publicity and HMRC is expected to target smaller business to check the quality of their records during 2011.

The issue for businesses is a complex one, but the key points to bring out in regard to poor records keeping are:

- If the records are shown to be poor then the officer has in effect "broken the accounts" to use an old term. This means that the figures on the tax return cannot be relied upon and the officer will be starting to make assessments.

- Basic integrity of records is clearly identified in the guidance as an element of "taking reasonable care". So a taxpayer with very poor records faces not only a discovery assessment – for a period of 6 years due to the failure to take reasonable care (the period would otherwise be 4 years) but also potentially penalties of up to 30% of the tax to which he is assessed based on that failure. The opportunity to make an unprompted disclosure is lost, because the integrity of the records is only disputed when a compliance check is under way
- However limited your client's abilities it is up to him (by law) to keep sufficient records so that any tax return prepared from them is correct and complete. There are penalties over and above those described above for businesses with inadequate records.

There is not presently any evidence that HMRC is planning a "big stick" approach to smaller businesses, but there is evidence that the adviser should be aware of that this is an area which will benefit closer examination as far as HMRC is concerned.

"Interventions"

Budget 2006 included details of HMRC's plans to use new approaches to compliance, extending the range of compliance interventions to include a variety of measures more appropriate to broadly compliant taxpayers. Although this occurred some years ago, there are some crucial outcomes from the work done then which have a bearing on what is happening in 2011!

The consultation on the proposals had only just closed when HMRC announced that a trial of the new methods was commencing, and this started on 10 July 2006. The press release announcing the trials included the following comments from HMRC :

"With these new approaches we aim to trial a lighter touch, providing help where needed, and freeing up resources to tackle serious and deliberate non-compliance.

"We hope that the new approaches ... will prove to be more flexible and less time consuming for businesses, tax agents and HMRC staff.

After the trial started there was strong criticism of the trial and the specific letters produced for use in the trial, and in particular, the CIOT asked for the trial to be stopped until the issues could be addressed. Although this did not happen, the next phase of the trial was suspended until more thought could be given to developments and feedback.

The profession's view was that the trial was set under way far too quickly, and many practitioners were concerned as to whether they should be agreeing to participate in the trial at all (participation was voluntary).

Although a second trial was intended to commence in October 2006 when the first pilot ended, HMRC announced that no further testing will be carried out until the results of the work done so far have been evaluated.

The six new interventions trialled during 2006, were as follows :

1. Real time record review: A current business record-keeping review, i.e. checking current records and record-keeping procedures to make sure they meet the standards that HMRC consider to be appropriate in order to record the results and make returns accurately. It is likely that HMRC will focus on cash transactions and will look at both direct and indirect taxes. HMRC will advise taxpayers where improvements are needed.

2. Short risk review: Issuing a questionnaire to a business based on a risk profile developed for the particular trade, industry or behaviour grouping to which the business belongs. HMRC will aim to obtain explanations about the business and weigh up if there are likely to have been understatements.

3. Self audit: This will use letters or telephone calls (or both) requiring the taxpayer to consider potential risks around specific entries on his or her return, make any necessary adjustment and notify HMRC of the adjustment made.

4. Telephone contact: HMRC staff will contact taxpayers by telephone to outline why HMRC consider that an error has been made on the return and how any underpayment can be settled. The staff will use prepared scripts; we are told they will be trained in appropriate telephone and technical skills.

5. Correction challenge: This is similar to self audit but will be used where HMRC hold 'good quality information from a reliable source' (which includes reports of bank interest from banks) that there is an error. They will simply make an assessment or change a PAYE code to collect the apparent underpayment, tell the taxpayer they are doing so and ask for an explanation as to why the taxpayer included the wrong figure.

6. Real time health check: Approaching a target population where HMRC believe there are risks of non-compliance, telling the taxpayer what the risks are, and suggesting that they consider them when they complete their own returns.

Evaluating the pilot

Although the pilot was much criticised, there were a number of valuable developments which identified cause for concern, and a number of key lessons were highlighted. These are likely to shape compliance developments over the next few years, and indeed are likely to form the basis of the entire structure of compliance effort in the medium term.

The results of the evaluation of the pilot exercise were published in April 2007, and in all the review and analysis are an extensive piece of work running to many hundreds of pages. However, in summary, the following conclusions and lessons have been learned :

Key lessons learned

"Lessons learned from the pilots include:

- Taxpayers welcomed the opportunity to resolve more minor errors and queries as early and quickly as possible. There are real benefits for both the taxpayer and HMRC in having quicker alternatives to a traditional time-consuming enquiry;
- Tax advisers share our ambition to find more flexible intervention options and they are willing to work with us to develop these;
- Taxpayer safeguards must be properly considered; and
- Interventions must be tailored to the risk and the taxpayer to maximise their potential for success.

But perhaps the key lesson learned was that timely and fuller engagement with external stakeholders improves the design, development and delivery of new compliance interventions. "

Proposals for developing compliance procedures

The review of the interventions set out the methodology to be used in developing compliance checks for the future., as follows :

"The activity undertaken within the six pilots ended in October 2006. Since then the Compliance Reform Forum has been established bringing together representatives from HMRC, small business, the Low Incomes Tax Reform Group and the agents' community to discuss how to take forward work on developing a more flexible and customer-focused compliance assurance regime for HMRC. The key learning points and conclusions identified in this report have informed the development of that programme of work. A programme of work to take forward development of work on new interventions has been agreed, including:

- helping new business;
- better communication with HMRC through the use of email and telephony;
- sharing information on methods of risk assessment between HMRC and tax advisers to generate better understanding;
- sharing workflow processes to enable HMRC and tax advisers to understand the role of each party in assuring tax return compliance;
- reviewing and improving current intervention processes and exploring alternatives and safeguards;
- communication to interested parties about proposals and possible developments; and
- improved consultation framework and implementation.

Where the above programme involves developing and testing new approaches to improve how HMRC checks and assures compliance the following points of learning from the pilots should be considered:

- Development work on interventions should begin with an identified risk and design the type of intervention and intervention mix which is proportionate and effective to address that risk;
- Where bulk data is the basis of an intervention, to reduce unnecessary burdens on compliant taxpayers HMRC must be careful in checking third party data before the intervention is made. This includes, where appropriate, checking information held by HMRC, such as the "white space" on self-assessment returns ;
- Assurance of the quality and technical accuracy of the outcome of an intervention is essential to safeguard the taxpayer's position and to enable appropriate evaluation. Quality assurance should form an integral part of the future testing of new approaches to compliance work;
- The approach and design of the opening contact with taxpayers is important in influencing the likelihood of a positive response. The communication methods used to deliver an intervention should be appropriate to the risk and to the taxpayer. The purpose and expectation of the intervention should be clear and easily communicable. External stakeholders could provide assistance and advice to improve the design of the contacts or approach to meet both HMRC's and taxpayers' needs;
- Full and timely engagement with external stakeholders will improve the design, development and testing of new approaches; and
- Where less formal compliance interventions are to be tested or used, taxpayer safeguards should be established which are clear, adequate, robust and understood by HMRC, taxpayers and agents."

Much of the above guided the development of the new powers brought forward in Finance Act 2008, but there is a deeper message in the review of the trial, in relation to some of the particular areas studied.

Lessons in relations to the results themselves

Quotes from the executive summary of the entire exercise included the following, which does not bode well for the small business community :

> "Some taxpayers are not able to declare the correct amount of tax because their business records are not adequate. If this is left unaddressed it could subsequently lead to more significant errors;"

HMRC identified a key risk to the integrity of the tax system posed by the poor records they observed in part of the trial. It would be naïve to expect that this conclusion would not form a major part of the compliance drive in the future. More specific concerns are raised in the detailed review of the work done in relation to record keeping.

Detailed analysis – record keeping

The following is an extract from the evaluation of the Real Time Record Review pilot exercise, which will give an idea of how HMRC went about this type of work and the rather worrying results they came up with.

Real Time Records Review

Real Time Records Review checks business records before the relevant tax return is submitted. It provides an opportunity for HMRC to discuss record keeping with the taxpayer and examine the completeness and adequacy of records in order to form a view on the taxpayer's ability to make accurate tax declarations. Any errors found during the examination are corrected and the taxpayer given guidance to help prevent future errors occurring.

There are no statutory powers underpinning ITSA and CTSA which allow HMRC to inspect taxpayers' records before the submission of the relevant tax return, which means Real Time Record Review can only be carried out with the taxpayer's agreement. Although such inspection powers exist for VAT and PAYE they were not used in the pilots. The pilots were used to test an integrated approach across ITSA/CTSA, VAT and EC where appropriate risks were identified.

Taxpayers, or their agents, were contacted by telephone or letter to arrange a visit to the business.

The visiting officer would consider the specific risks identified for Real Time Record Review and:

- ask questions to establish what systems were in place to ensure the taxpayer could complete their returns accurately;
- examine a selection of records to confirm that the systems and controls operate in the manner described by the taxpayer;
- reach a conclusion about whether the systems in place gave reasonable assurance that the returns will be accurate and complete; and
- discuss those conclusions with the taxpayer.

Following the visit, if no errors were identified requiring an assessment, based on their opinion of the adequacy of the records, the officer recorded their view on the adequacy of the records as either:

1. The Real Time Records Review demonstrates that, from the records reviewed and information given, the taxpayer is keeping adequate books and records to give reasonable assurance that returns will be accurate and complete;
2. The Real Time Records Review demonstrates that, from the records reviewed and information given, the records kept may not be wholly adequate to ensure that returns will be accurate and complete;
3. There is strong evidence that books and records retained are inadequate and would be incapable of ensuring that returns will be accurate and complete; or
4. Books and records are not maintained.

A follow up letter was sent to the taxpayer confirming matters discussed e.g.:

- what improvements could be made to the systems; and
- how any errors discovered during the review could be corrected.

Those taxpayers who did not respond to the telephone call were sent a letter suggesting a provisional date and time of appointment. If there was again no response the officer visited the premises at the suggested time, although the taxpayer could still exercise their right not to participate.

Risk	Relevant regime	Taxpayer group	No of interventions	No of interventions closed	Non-participation rate
RTRR 1 – cash handling procedures	VAT EC ITSA CTSA	Restaurants	231	218	70%
RTRR 2 – record keeping arrangements may not keep pace with rapid growth	VAT EC ITSA CTSA	Rapid Growth – not trade specific	112	110	76%
RTRR 3 – subsidiary records (e.g. membership, day user cash receipts) may not be retained	VAT ITSA CTSA	Sporting Activities	244	235	60%
RTRR 4 – cash handling and retention of subsidiary records (e.g. booking sheets, staff records)	VAT ITSA CTSA	Hotels	248	241	54%
RTRR 5 – cash handling procedures and recording of subsidiary income such as commissions	EC ITSA CTSA	CTNs	246	238	77%
RTRR 6 – casual labour; completion and retention of subsidiary records	EC ITSA CTSA	Garages	243	239	67%
RTRR 7 – cash handling procedures	ITSA CTSA	Restaurant & Takeaways	243	224	63%
Total			1567	1505	66%

Participation

The more active nature of Real Time Record Review had a big impact on taxpayer participation in the pilot and resulted in a 34% participation rate38, the lowest of the 6 new interventions. Of the 993 who did not participate 44% were declined by agents who cited a number of reasons:

- concerns over the lack of legal safeguards;
- the lack of professional indemnity insurance cover for liabilities arising outside traditional interventions;
- encroachment on the agent's role to advise the client on record keeping; and
- the summer holiday period.

Cost-effectiveness

The focus of Real Time Record Review is to identify non-compliance at an early stage and put things right now and for the future. Nonetheless, the pilot identified current errors valuing £229,204 yield and £209,700 potential yield. Overall the cost of the intervention exceeded the value of the additional yield identified. Within that there were wide variations, for example one risk profile produced a return of £5.30 yield for every £1 cost (these statistics exclude amounts escalated to Local Compliance teams). A number of factors contributed to this:

- The voluntary nature of the Real Time Record Review meant that only those taxpayers willing to participate did so. Potentially non-compliant taxpayers who did not participate were not addressed; and
- The pilot was artificial in that staff did not have access to alternative work during periods of non-activity. If this work were to be carried out in future, other work would be available and staff would be deployed more flexibly.

The Real Time Record Reviews revealed a significant number of cases where visiting HMRC officers believed record-keeping needed to be improved, with 36% having 'inadequate' or 'not wholly adequate' records (would not ensure that returns will be accurate and complete) and 14% resulting in errors. Although by no means conclusive, this suggests compliance problems in the risks targeted and the value of an early intervention to prevent errors and deter non–compliance. By identifying these levels of poor record-keeping Real Time Record Review has played a role in educating taxpayers who need support.

Yield arising from past mistakes is an important measure for any compliance intervention, but for Real Time Record Review the key success indicator must be the impact on future compliance behaviour. There is currently no such agreed measure of future revenue benefit in place. This would have to be developed and more evidence gathered for longer term evaluation.

Reduced burdens

Some of the responses from participants interviewed in the customer experience research showed a favourable response to Real Time Record Review, although some individual respondents complained about the time taken to resolve outstanding issues. There was also criticism at the lack of commercial awareness and understanding by some officers. Both aspects reflected some officers' limited experience of this type of work which would need to be addressed by more extensive training than that provided for the pilot.

Some respondents to the customer experience research felt that this was a good opportunity to correct mistakes or confirm that their record-keeping was adequate. Others, however, did not feel that the additional costs were justified. Agents were often present at the visit, some at the taxpayers request and others because they had requested to be present themselves.

Conclusions

The standard of businesses' record keeping is variable and often influenced by the nature of the business, its size and maturity. Even though the pilot was voluntary, the level of record keeping among those willing participants demonstrated a sizeable potential problem around the adequacy of records kept. It is reasonable to assume that the position would be no better, and could be worse for those who are unwilling to engage with HMRC voluntarily. Earlier identification of such problems could limit errors and problems in the future.

While a voluntary intervention of this nature can assist as part of an educative programme of support, it is unlikely to target those taxpayers who would most benefit from the intervention. That is to say taxpayers whose approach to their tax affairs lacks sufficient care and those who are deliberately non-compliant are the least likely to respond to a voluntary approach.

The following table shows the outcomes for the participants

Table RTRR 1.2 – Summary of Outcomes for Participants

Adequate records	Not wholly adequate	Totally inadequate	Errors for escalation	Errors discovered	Records not being kept
327 (64%)	106 (21%)	4 (1%)	45 (9%)	27 (5%)	3 (1%)

When an agent was involved, the following results were shown :

Table RTRR 4.1 – Agent Involvement by Outcome

Outcome	Agent Involved		Not involved	
Adequate records	108	58%	219	17%
Not wholly adequate	42	22%	64	5%
Totally inadequate	3	2%	1	0%
Errors for escalation	13	7%	32	2%
Errors discovered	7	4%	20	2%
Records not being kept	0	0%	3	0%
Non-Participation	14	7%	979*	74%
Total cases closed	187 (12%)		1318 (88%)	
Yield £	£53,287		£175,917	

*427 of these cases were directly refused by the taxpayer's agent and a further 366 had registered agents with HMRC but made the refusal themselves. See Table 4.3

Table RTRR 4.2 – Agent Involvement by Outcome (Participants Only)

Outcome	Agent Involved		Not involved	
Adequate records	108	62%	219	65%
Not wholly adequate	42	24%	64	19%
Totally inadequate	3	2%	1	0%
Errors for escalation	13	8%	32	9%
Errors discovered	7	4%	20	6%
Records not being kept	0	0%	3	1%
Total cases closed	173 (34%)		339 (66%)	

Table RTRR 4.3 – Agent Involvement for Non-Participants

	Non-Participants
Agent Actively Involved	441 (44%)
Agent Acting but not Actively Involved	366 (37%)
No Agent Acting	186 (19%)
Total	993

What this means to your clients

The powers introduced in Finance Act 2008 allow HMRC to carry out checks in-year. It is quite possible for the officer to carry out a type of real time record review to establish the reliability of the records in the current period. If these are found to be inadequate, the officer is then at liberty to revisit previous years, opening an enquiry into open years, but raising discovery assessments for up to 6 years on the basis of the poor record keeping and potential errors. You will notice that the sectors selected were cash based businesses, and the record keeping failures related mainly to the recording of cash income on receipt.

There are indications that 2011 is the year that a major programme of work is about to start on small business record keeping and the sensible adviser will be ensuring that his clients are ahead of the game!

Contributed by Rebecca Benneyworth

Lecture B631 (10.29 Minutes)

Business Tax

Mobile phone in own name

The following question recently appeared on the Taxation forum.

"My client operates his business through a limited company of which he is the sole employee, director and shareholder.

He has a mobile phone, the contract for which is in his own name, but which is used for business purposes. The monthly charge for the phone is paid by the company, but the HMRC inspector is now seeking to disallow the service charge – which he equates to a rental charge for the phone – while allowing a proportion of the call costs.

Is this correct or should the company be allowed to obtain a full allowance for the payment with the possibility of a benefit charge on the director for private use?"

Extract from Query 17,715 – Fone Tone

Employee provided phone

Where the employer reimburses the cost of all calls, this is normally deductible from the company's profits, either because the calls themselves are for business, or because it is a form of reward for the employee.

The employee can deduct expenses reimbursed if they are 'wholly, exclusively and necessarily' for the business.

So if he has a phone with a contract which charges him by the minute, and business calls are identified and reimbursed, he can claim a deduction under s 336.

Free minute contracts

Mobile phone contracts are normally priced to provide so-called 'free minutes' in exchange for a fixed monthly sum.

In HMRC's view, this monthly sum is paid for the rental of the phone, not for the calls. Their guidance only allows a deduction where the monthly amount is exceeded, and the excess relates to business calls; see the example at *Employment Income Manual* para EIM32951. If only the fixed monthly sum is paid, they say that 'no deduction can be permitted because no expense has been incurred in making the business calls.'

In fact, the 'fixed sum' is selected to take account of the estimated usage. So the more 'free minutes', the higher the fixed monthly amount. In many contracts, the amount for 'line rental' is tiny – phones can be rented for as little as £0.99 a month.

HMRC are thus wrong to say that no money has been spent 'wholly, exclusively and necessarily for the business': the reality is that a proportion of the sum expended is for business purposes, and should be allowed under the rule in *Caillebotte v Quinn* 50 TC 222, which HMRC accept also applies to employees (see *Employment Income Manual* para EIM31662).

HMRC are wrong to disallow the expense in the employer's computation.

Private use

If there has been private use, there is a benefit charge, although HMRC's approach over-estimates its quantum.

Contract as agent

Is it possible that the client has entered into the contract as an undisclosed agent for the company, and thus the contract is actually with the employer? This would mean that the benign rules in s 339 could be used.

This could be proved by:

- A board minute noting that the contract had been taken out in the director's name and that the company is accepting full responsibility for it on the basis that the director acted as agent; or
- showing from the phone records that the overwhelming use of the phone is for business and that payment of all bills directly by the company would lead a reasonable man to conclude that the phone is a company phone.

Corporation Tax

Consider making claims for R&D relief

On 29 October 2010, HMRC published the most recent statistics for company claims for research and development (R&D) tax relief and the related vaccines relief.

In 2008/09, 0.38% of companies were making R&D tax relief claims. This is a very small proportion, even allowing for the fact that there are a huge number of companies on the register that will be dormant or near enough dormant, or exceptionally small.

So why is the relief noy being claimed?

Minimum spend criteria

Companies have to spend at least £10,000 on qualifying costs in a 12-month accounting period in order to make a claim. Undoubtedly, there will be some small companies carrying out R&D who cannot reach this threshold.

The usual scenario for a small 'one-man band' company is that the owner-director takes nothing from the company, draws off a loan account or pays himself a small salary and the balance as dividend, as this form of profit extraction is the norm and usually the most tax efficient.

This advice is based on the premise that, although salary attracts corporation tax relief, the National Insurance costs outweigh this, thus making dividends more favourable.

It is necessary to do some number crunching, but in R&D cases the extraction policy may need to be revisited if that corporation tax deduction is going to be, at least in part, given at 175%.

Pre-trading R&D

For pre-trading companies carrying out R&D, the pre-trading qualifying costs can be treated as deductible when incurred by making an election.

This will usually generate a loss as there is no other income, resulting in an R&D tax credit claim for tax-free cash, often amounting to the PAYE and National Insurance already paid to HMRC.

We are not doing R&D

HMRC's definition and guidance on the term can be summarised as a project that 'seeks to achieve an advance in overall knowledge or capability in a field of science or technology through the resolution of scientific or technological uncertainty'.

By shifting your mindset towards 'development' instead of 'research' and considering 'technology' as well as 'science' the scope for making a claim becomes much wider.

Particular industries to be aware of are high-tech, precision and electronic engineering; certain IT-related activities; and even manufacturing when looking to develop new products that involve either technology in the product or in the process to make it.

The R&D does not have to be the end product, but can be an internal process.

Rethinking which companies may qualify for the relief may open up your client base to many additional claims for R&D tax relief.

Claiming is too complicated

'No it is not'. A claim for the relief is made on the company's tax return and most, if not all, corporation tax software will carry out the necessary uplifts and reliefs.

Quantifying the claim and pulling together supporting documentation is vital though. There is certainly a skill in pulling together some background narrative to accompany the claim. Pitching the wording at the correct level – not too technical, not to simplistic – while concentrating on the advancements sought and uncertainties faced can be tricky.

Some companies have a tendency to provide a life history of the company and a lot of detail as to what the new product or process will do as opposed to why it is considered to be R&D. Once again, with a little hand-holding the client and adviser can soon produce something worthy of submission.

Costs outweigh the benefits

A small claim just exceeding the minimum spend of £10,000 is only worth £1,575 in additional tax savings. For a company that has never claimed before, and needs a lot of advice, it does become more difficult to justify.

It is quite rare for a company to claim only for one accounting period, so compiling a report and qualifying expenditure for two years at once reduces the annualised cost. Costs may reduce in the future when the client understands the process better and an agreed template for the claim has been produced.

Identifing R&D costs

Normal record-keeping rules for companies apply and, as R&D costs are already within the company's records, they will exist.

The main problem lies with quantifying suitable percentages of employees' time to R&D. HMRC have recently taken a much stronger stance, and rightly so, challenging claims where an individual is quoted as devoting 100% of their time to qualifying R&D.

Technical staff who are not owner-directors and have little or no involvement with administration, marketing, sales or strategy may indeed contribute 70% to 90% of their time to qualifying R&D.

The owner-director's time is, however, taken up doing many tasks, usually juggling many balls at once, and it is much more difficult to measure. A suitable percentage of 20% to 40% is often reasonable in smaller businesses, although this will vary from client to client.

A proportion of employer pension contributions for R&D employees qualifies. With the new pension rules from April 2011, any such employer contributions that are R&D qualifying costs will attract an enhanced corporation tax deduction.

A proportion of heat, light and water used in R&D also qualifies. Methods seen include a proportion along similar ratio that staff R&D costs are when compared with the total wage bill, or R&D materials compared with total purchases. This is rarely a big enough number to worry about.

We got a grant instead

If a grant is received towards R&D that is not notified state aid, then a SME can claim under the SME scheme, obtaining the 75% additional relief, on the amount of shortfall in costs between the total qualifying spend and that covered by the grant.

The SME can also claim, under the large scheme (even though it is an SME), for the amount that was covered by the grant, the large scheme providing a further 30% relief.

If the grant is notified state aid then, regardless of the size of that grant, an SME cannot claim the SME R&D tax relief.

However, once again, it can claim under the large company scheme.

It seems that most R&D grants are notified state aid (the grant provider can confirm this if the documentation does not make it clear) and, therefore, all SMEs in receipt of an R&D grant should explore the strong probability that some form of enhanced tax relief will also be available.

Where a state aid grant is for a specific R&D project and the company carries out other qualifying R&D, a claim can be made under the SME scheme for the non-grant projects and under the large scheme for the grant-funded projects.

Summarised from an article by Nigel Holmes writing in Taxation

Lecture B632 (14.51 Minutes)

Corporation tax reform

On 29 November 2010, the Chancellor announced a reform of corporation tax.

The reforms include proposed changes to:

- the taxation of controlled foreign companies (CFCs)
- research and development (R&D) tax relief
- the taxation of intellectual property (IP)
- the taxation of foreign branches

The reform document sets out a timetable for the intended changes over the next few years. However, it should be noted that discussion in some areas has been going on for many years so time will only tell whether these progress as planned. However, there are some positive steps forward and it may slow down the rate of companies leaving the UK.

The taxation of controlled foreign companies (CFCs)

The CFC consultation is in two parts: one focusing on interim improvements and the other considers medium term reforms to the CFC regime.

The interim improvements to the CFC regime are intended to be introduced in Finance Bill 2011. The main interim improvements are to:

- create exemptions from the CFC provisions for certain 'foreign to foreign' intra-group activities, where there is no risk from the artificial diversion of profits outside the UK,
- create exemptions from the CFC provisions for companies holding IP outside the UK where the IP being exploited, and the CFC itself, have minimal connection with the UK business,
- extend the scope and duration of the current temporary exemption where a UK company acquires a foreign subsidiary
- increase the current de minimis exemption from its current level of £50,000 to £200,000,
- extend the transitional rules for superior and non local holding companies (as included within the Finance Act 2009) so that they remain in place until the completion of the full CFC reforms due in 2012.

The medium term reforms are expected to be legislated for in Finance Bill 2012. The current key proposals are to:

- create a mainly entity based regime which only targets the proportion of profits which are artificially diverted from the UK, this will include limited exemptions for:
- finance companies - a charge will only arise under the new regime where the finance company's debt to equity exceeds a set ratio, allowing groups to manage their overseas finance by the use of such companies while protecting the UK tax base, and
- excess cash - the exemption for finance companies is proposed to be extended to trading companies where they hold excess cash and receive only incidental or ancillary income from it
- introduce a new approach for companies holding intellectual property (IP), targeting cases where excessive profits have arisen and these (or a proportion of these) have been artificially diverted outside of the UK

R&D tax relief

The scope of the consultation on R&D tax relief covers the following main areas:

- structure and scope of the regime - this includes consideration as to:
- how to ensure that the relief is targeted at the costs which are directly related to genuine innovative activities, and looks for comments on extending the definition of qualifying costs in some areas and potentially restricting other areas (such as internal use software),
- considering the definition of R&D, as currently defined by the guidance issued by the Department of Business, Innovation and Skills, and
- considering clarification in the area of production
- considering a refocus of the relief to:
- promote more investment in R&D by the smallest companies, and
- ensure that the current vaccine research relief is effective
- look at improvements which could be made to the claims process to make the relief more accessible, particularly to small companies with limited resources

The consultation considers whether relief should be focused on high-tech companies because of their particularly strong link to R&D. This isn't defined. However, it would be a shame if the relief is to be withdrawn from companies that allocate only a small proportion of their overall spend to R&D. If innovation is driving future income for the UK it should be incentivised, regardless of the shape and size of the investing company, and that relief should not be limited by yet another condition.

Equally hopefully R&D tax relief should not be restricted by sector or by type of technology. Experience shows that R&D is pursued in a wide range of sectors, including – but in no way limited to – life sciences, manufacturing, engineering and IT.

More focus needs to be on helping early stage SMEs and start-ups, which face higher barriers to maintaining a sustained R&D programme. These schemes clearly offer real cash incentives to companies without a major administrative burden or cash spend for the Government.

The taxation of intellectual property (IP)

This consultation considers the introduction of the 10% tax rate patent box regime.

All patents first 'commercialised' after 29 November 2010 are expected to qualify under the patent box regime and it is anticipated that the regime will apply in respect of profits received from such patents on or after 1 April 2013.

The taxation of foreign branches

The consultation document sets out the detailed proposals for the reform of the taxation of foreign branches. Draft legislation and explanatory notes on this reform are expected to be issued in the near future.

The scheme is proposed to provide an exemption from UK tax on branch profits, where a company makes an irrevocable election. Where an election has been made, a company will not receive relief for any branch losses in the UK. The regime will apply to branches in any country or territory for large and medium companies. However, for small companies, it will only apply to branches in countries who have a tax treaty with the UK. The scheme is expected to be introduced for accounting periods commencing on or after a specified date in 2011.

Altogether, the corporate tax proposals provide the sort of certainty many companies have been asking for but the decision to make companies decision on foreign branch taxation irrevocable will have taken some by surprise.

Contributed by Francesca Lagerberg

Lecture B633 (7.59 Minutes)

Holland v CRC, Supreme Court

The taxpayer and his wife ran a company, Paycheck Services Ltd, which dealt with the financial affairs of contractors who preferred not to set up their own companies. In 1999, the company was restructured so that the taxpayer and his wife each held 50% of the shares in a new company PSL.

This company held 100% of the shares in two other new companies, PDS and PSS. PDS and PSS were incorporated to act as director and secretary of 42 trading companies, known as the composite companies.

Each of the composite companies had a single voting 'A' share and some 50 non-voting shares. The A share was held by another new company, PST, of which the taxpayer and his wife were directors and held the share capital.

The aim of the restructure was to ensure that the companies all paid the small companies rate of corporation tax. To qualify for that rate, the companies had to be unassociated, but the effect of TA 1988, s 417(3) was that the taxpayer was treated as controlling all the composite companies, thus they would be associated.

The taxpayer, however, claimed that extra-statutory concession C9 'Associated companies' applied and on that basis, the companies were not associated. HMRC disagreed, saying that the taxpayer and his wife were de facto directors of the composite companies.

The companies continued to pay dividends regardless, with the result that they had insufficient funds to pay the corporation tax. The companies then went into administration, owing some £3.5 million in tax.

HMRC issued orders saying that the taxpayer was guilty of misfeasance and breach of duty by allowing the companies to pay dividends without making provision for the full rate of tax and should contribute to the assets of the insolvent companies. The matter proceeded through the courts to the Supreme Court.

The Supreme Court said the taxpayer had been doing no more than discharging his duties as a director of the corporate director of the composite companies.

HMRC had not been able to show anything to the contrary. On the facts, he had not been acting as a de facto director of the composite companies and was not therefore responsible for the misuse of their assets.

HMRC's appeal was dismissed.

One-off pension payment on cessation of trade

The following query recently appeared on the Taxation Forum.

"A new corporate client will be ceasing business on 31 March 2011, having traded for approximately eight years. A not insubstantial cash reserve will be distributed as part of the members' voluntary winding-up as soon as possible thereafter.

The usual remuneration package consists of salary of approximately £5,000, being topped up with dividends and higher rate personal taxation has been avoided. Historically, on an annual basis, the company has been paying £3,600 into one of the director's pension policies.

The company has been generating annual profits well in excess of £200,000 and is considering paying a one-off additional pension contribution into the above policy of, say, £200,000 early in 2011, certainly before the cessation of the trade.

If allowable, it will reduce the profits of the year by the full amount, thus saving 21% corporation tax. Upon the liquidation of the company, the value of the shares will be £158,000 lower (i.e. £200,000 less 21% tax), thus saving a further capital gains tax charge of 10%, entrepreneurs' relief being available.

While I believe everything is in order for maximum tax advantage, I have heard in general conversation that the corporation tax allowance for the one-off premium very much depends upon which Inspector's desk the tax file lands on."

Replies

Contribution to benefit the trade?

The business is ceasing. This means that HMRC may argue that instead of the pension premium being incurred 'wholly and exclusively in carrying on the trade, it is instead incurred as part of the process of winding up the company.

Since the client does not have a contractual obligation to make the payment and it is not being made to the pension schemes of unconnected employees performing duties of similar value, HMRC will probably treat the payment as not being made wholly and exclusively for the benefit of the trade.

See Example 2 of paragraph BIM46040 of the *Business Income Manual* and also BIM38310 refers to the case of *CIR v Anglo-Brewing Co Ltd* [1925] 12 TC 803

Excessive contribution

The client's director appears to be a controlling director. With regards to controlling directors, paragraph BIM46035 of the *Business Income Manual* directs the inspector to consider whether the pension contribution is excessive for the value of the work undertaken by the director.

The client has been paying the director a low salary since it also paid him dividends. Presumably, this was done to reduce the tax on the profits extracted by the director from the client.

Although the director's services are probably worth more than the salary that he is earning, they may still not be worth the proposed pension contribution.

It is also difficult to argue that the director's services are worth more than the wage he earns on the basis that his salary was kept low to reduce the tax borne by the client's profits extracted by the director.

Alternative

One alternative is for the company to pay remuneration to the director and for the director to pay the pension premium.

This will ensure that the company obtains relief on the wages and the director will obtain higher rate relief on the premium, but depending on the director's age there will be a National Insurance liability.

As an aside

The general rule of course is that – for annual premiums over £3,600 – the taxpayer must have earned income equivalent to the amount paid, until capped by the annual limit.

However, with a company director, the company can pay the premium direct to the pension company. There does not need to be an equivalent level of salary as the premium payment is effectively part of the director's overall remuneration package. As such there should be no problem with the premiums being allowable as a wholly and exclusively for the purposes of the trade' in the company's hands.

Advance Pricing Agreements – SP 2/2010

This Statement of Practice ("SP") updates an earlier Statement on Advance Pricing Agreements ("APAs"), published in 1999. The legislation that relates to APAs, formerly found at Section 85, Finance Act 1999, now appears at Sections 218 -230 of the Taxation (International and Other Provisions) Act 2010 ("TIOPA 2010"). This SP is intended to provide guidance about how H.M. Revenue and Customs ("HMRC") interprets the APA legislation and applies it in practice.

APAs – What are they and when might businesses consider one?

1. An APA is a written agreement between a business and the Commissioners of HMRC which determines a method for resolving transfer pricing issues in advance of a return being made. When the terms of the agreement are complied with, it provides assurance to the business that the treatment of those transfer pricing issues will be accepted by HMRC for the period covered by the agreement.

A bilateral APA – as discussed below – will provide a similar assurance in respect of the tax administration ("Administration") dealing with the entity at the other end of the transaction.

2. An APA enables businesses to achieve certainty that the transfer pricing issues covered by the agreement will not be part of any enquiry into their self-assessment tax returns for the relevant period and so provides greater certainty over their tax liabilities. HMRC has also found that where there is considerable difficulty or doubt in determining the method by which the arm's length principle should be applied, the transfer pricing issues can be more efficiently dealt with in real time as they arise rather than retrospectively years later when, for example, key personnel in the business may have moved on.

3. Sub-section 218(2), TIOPA 2010, sets out the transfer pricing issues which can be the subject matter of an APA. An APA can be used to resolve questions relating to the following broad situations giving rise to transfer pricing issues:

a. Transfer pricing between separate business enterprises where questions may arise as to the determination of the arm's length provision under the rules in Part 4 TIOPA 2010.

b. Attribution of income or profit between parts of a business enterprise which operates in more than one country where questions may arise as to the taxable income to be recognised in any such part. (Note – this is conceptually a similar problem to transfer pricing and any references to "transfer pricing issues" in the remainder of this document should be read as including such attribution issues.)

c. Across the UK oil-related ring-fence.

4. The potential scope of an APA is flexible. It may relate to all the transfer pricing issues of the business or be limited to one or more specific issues although Thin Capitalisation issues will generally be dealt with via a separate Advance Thin Capitalisation Agreement ("ATCA"). There is no requirement that the commencement of an APA should coincide with the commencement of the arrangements which it addresses so it may apply to pre- existing issues.

5. The APA legislation does not specifically provide for a determination that a permanent establishment ("PE") does not exist however it may be possible for the APA to include a determination that the income to be attributed to a potential PE is nil.

6. HMRC's Business International Directorate ("BI") has responsibility for all applications except enterprises operating in the North Sea (for which the Large Business Service's Oil and Gas Sector is responsible). Otherwise, BI will involve such specialists and delegated competent authority officials as is necessary, and will ensure the business' Customer Relationship Manager ("CRM") is involved.

7. HMRC do not levy any charge on the business for their assistance during the APA process but potential applicants need to be aware that some other Administrations may do. HMRC can advise on this at the Expression of Interest stage (see below).

Unilateral, bilateral or multilateral agreement

8. A binding agreement between a UK business and HMRC in accordance with Section 218, TIOPA 2010, is referred to as a "unilateral APA". Although this agreement confirms the tax treatment in the UK, it does not determine how the issues are to be resolved in any other country involved. Consequently, it does not normally eliminate the risk of double taxation in relation to the transfer pricing issues it addresses. In order to achieve that comprehensively in the case of cross-border transfer pricing issues where a Double Taxation Agreement ("DTA") exists between the UK and the other country containing a Mutual Agreement Procedure article, HMRC would have to reach agreement also with the Administration of the other country: this is referred to as a "bilateral APA".

9. Businesses operating in several countries may wish to seek APAs that involve all the relevant Administrations affected by the transfer pricing issues. The term, "multilateral APA," has been used to describe such agreements, but there is no discrete mechanism for reaching multilateral agreements, and multilateral APAs are strictly multiple and complementary bilateral APAs.

10. Multilateral agreements may be more appropriate where there is essentially only one activity, but several enterprises or parts of enterprises contribute to it. For example, where an enterprise of the UK is engaged in global financial trading through branches in countries X and Y, it may be appropriate for similar agreements to be reached between HMRC and country X and HMRC and country Y in order to determine how the profits from the activity are to be allocated to each of the three countries in order to eliminate double taxation. In such a situation HMRC will adapt the bilateral framework in order to reach agreement on a trilateral basis, subject to the acquiescence of the other Administrations and any constraints on exchanging information imposed by the relevant DTAs.

11. HMRC generally recommends that APA applications are bilateral rather than unilateral except where:

a. Applicants are able to persuade HMRC that the extension to a bilateral APA would unnecessarily complicate and delay the process; or

b. The other party to the transaction is resident in a jurisdiction with which HMRC has no treaty or where HMRC is aware that the treaty partner has no APA process; or

c. There is considered to be little extra to be gained by seeking a bilateral agreement. For example where the UK is at the hub of arrangements with associated enterprises in many different countries and where the trade flows involved with any one particular country are relatively modest in scale.

12. Where there is an appropriate DTA in place, and HMRC considers that a bilateral APA would be more appropriate, HMRC may communicate with the other Administration if a unilateral is sought, to ascertain whether that Administration would consider entering into a bilateral APA process. Alternatively, (see Section 229(2), TIOPA 2010), HMRC's ability to give effect to a mutual agreement reached with a treaty partner to eliminate double taxation under the terms of a treaty will not be restricted by the terms of a unilateral APA.

Who may apply for an APA?

13. An APA may be requested by

a. any UK business, including a partnership, with transactions to which the provisions of Part 4 TIOPA 2010 apply;

b. any non-resident trading in the UK through a Permanent Establishment;

c. any UK resident trading through a Permanent Establishment outside the UK.

14. Every APA request will be considered on the basis of its particular facts and features, but generally HMRC will be looking for one or more of the following characteristics:

a. The transfer pricing issues are complex rather than straightforward. To HMRC "complex" means there is doubt as to how the arm's length standard should be applied. Conversely, where reliable market comparables can be readily identified for the transaction(s) in point, that should enable transfer pricing methods to be employed in accordance with the OECD Transfer Pricing Guidelines, and HMRC is likely to regard such a situation as "straightforward".

b. Without an APA, it is likely that the taxpayer's transfer pricing policies or issues would not be regarded as "low risk" and/or there is a high likelihood of double taxation.

c. The taxpayer seeks to implement a method which is highly tailored to its own particular circumstances. HMRC will be willing to consider an innovative proposal providing it is compliant with OECD Guidelines, and not one that HMRC considers Treaty Partners would regard as being overtly tax aggressive.

15. APAs will not be declined solely by reference to the size of the transactions giving rise to the transfer pricing issues because HMRC recognises that complex transfer pricing issues can be encountered by smaller businesses as well as by large multinationals. However many small and medium enterprises are exempt from the UK transfer pricing legislation by virtue of Section 166 TIOPA 2010 and so there may be limited occasions where the APA process will be appropriate for smaller businesses.

16. Since April 2004 UK-to-UK transactions have been subject to transfer pricing legislation: but, HMRC does not generally see such transactions as likely to warrant an APA. However some UK-to-UK transactions, for example oil-related ring fenced trades, are specifically provided for in legislation.

17. When a UK business does obtain an APA and the provision in question is made or imposed with a related UK business Section 222 TIOPA 2010 enables the other UK business to claim to have their profits adjusted in line with the APA where they are disadvantaged. However, HMRC seeks to avoid such issues by encouraging the business to agree wherever possible that the transfer pricing methodology will determine the commercial charge for the provision as well as the charge for tax purposes.

The initial contact – The expression of interest process

18. The APA process is initiated by the business but HMRC always strongly recommend that an enterprise interested in applying for an APA contacts it first to informally discuss its plans before presenting a formal application. This is to ensure that the resources of the business are not wasted on an unsuitable application and to ensure that the detailed work that will need to be undertaken by the business in finalising its application is focused on relevant issues. It also gives HMRC an opportunity to outline a realistic anticipated timetable for agreeing an APA based on past experience, or to discuss other practical "process" issues with the business.

19. The contact details for an Expression of Interest in an APA and for making an APA application in all cases except those involving oil taxation, is:

APA Co-ordinator (Ian Wood)
Business International
3rd Floor, 100 Parliament Street, London SW1A 2BQ

Telephone: 0207 147 2715 begin_of_the_skype_highlighting 0207 147 2715 end_of_the_skype_highlighting
Fax: 0207 147 2649
e-mail: ian.wood.@hmrc.gsi.gov.uk

20. For APAs involving North Sea and other offshore operations, the contact address is:

Competent Authority, Large Business Service Oil and Gas (Susan New) 3rd Floor, 22 Kingsway, London WC2B 6NR

Telephone 0207 438 7570 begin_of_the_skype_highlighting 0207 438 7570 end_of_the_skype_highlighting
Fax 0207 438 6910
e-mail: susan.new@hmrc.gsi.gov.uk

21. Any business uncertain as to which contact point is appropriate in their circumstances is welcome to approach either.

22. The Expression of Interest should generally cover:

a. The nature of the transfer pricing issues intended to be covered by an APA.

b. Details of the tax residence of the parties involved and the importance to the wider business of the transactions intended to be covered.

c. If decided upon, a description of the proposed transfer pricing method.

d. An indication of the nature of any current transfer pricing enquiries, competent authority claims, and any other relevant issues that the business is aware of in the context of the suggested APA.

HMRC's experience is that discussion of these issues at a meeting is much speedier and more productive than correspondence.

23. An Expression of Interest can best be evaluated where the identity of the business is known. However, if a business wishes to preserve anonymity until a decision in principle is made to proceed with the application, HMRC will be prepared to enter discussions without knowing the identity of the business providing all other information relevant to the proper evaluation of the request is supplied. However, HMRC will not make any commitment over acceptance into the APA Programme until the identity of the business is known. Otherwise, HMRC is usually able to indicate at the conclusion of an Expression of Interest discussion whether it will be prepared to consider an application for an APA.

24. In the event that HMRC considers that an application should not be admitted into the APA Programme, HMRC will advise the business of the reasons why HMRC takes that view, and will allow the business the opportunity to make further representations.

Term of the agreement and "Roll-Back"

25. An APA will be operative for a specified period from the date of entry into force as set out in the agreement. The business should propose an initial term for the APA taking into account the period over which it is reasonable to assume that the method for dealing with the relevant transfer pricing issues will remain appropriate. Typically the term is from three to five years.

26. It is possible that a chargeable period to which the APA relates may have ended before agreement is reached. Section 224, TIOPA 2010, allows the APA to be effective for that chargeable period and the agreement may set out any adjustments to be made for tax purposes as a consequence of the agreement.

27. The agreed transfer pricing methodology may be relevant for an earlier period and to the resolution of any transfer pricing enquiries raised for earlier periods if the particular facts and circumstances surrounding those years are substantially the same. Consequently, in such circumstances, the business may wish to consider using the agreement as a basis for amending a self assessment return or to request that the method for dealing with transfer pricing issues contained in the APA should be considered for resolving any transfer pricing enquiries to which it is relevant for earlier years. HMRC may also suggest that the "roll-back" of the APA is an appropriate means of a resolving a transfer pricing issue in earlier years although, in bilateral or multilateral cases, the possibility of doing so will also be dependent on the ability or willingness of the Administration of the other country or countries involved to do so.

28. Except where "roll-back" is being considered, the request for an APA in respect of future years will not in itself affect any transfer pricing enquiry into earlier years. However, to the extent such an

approach is appropriate and feasible, HMRC will co-ordinate the APA request in respect of future years with any transfer pricing enquiry in respect of prior years in order to improve overall efficiency and reduce duplication of enquiries.

The formal APA application

29. Where, following HMRC's indication that it is willing to consider the APA proposal, the business wishes to proceed, it should submit a formal written application. This APA application should also be copied to the business' primary business contact at HMRC – usually the business' Customer Relationship Manager.

30. Annex 1 to this document contains full details of the information that should generally be incorporated in the formal application. HMRC may, in practice, be flexible with such requirements where the circumstances of the particular case mean that a different approach will make for a better process. In a bilateral case, HMRC is often able to agree to work from the same format application as is mandated by the other Administration's procedures. These are issues best discussed with HMRC at the Expression of Interest stage. Annex 2 contains a diagram showing a timeline of the typical APA process for a bilateral case. The Annexes are available on the HMRC website.

31. The application should ideally be made before the start of the first chargeable period proposed to be covered by the APA, but HMRC may exercise discretion over this, for instance, when a bilateral is sought and the other Administration is prepared to allow the business more time to lodge its' application.

32. In the case of a bilateral APA the business will be asked to ensure that all information provided in the application supplied to one Administration is made available at the same time to the other Administration involved.

33. APA information is subject to the same rules of confidentiality as any other information about taxpayers. Information exchanged with treaty partners—for instance, in the course of reaching agreement on bilateral APAs—is also protected from disclosure by the terms of the Exchange of Information Article in the relevant DTA.

Evaluation

34. On receipt of an application HMRC will evaluate its contents and will seek clarification and further information from the business as necessary. The examination of the application should be a co-operative process in which the transfer pricing issues are discussed openly and access to relevant supporting information and documentation is made available. Lack of co-operation in these respects may result in HMRC declining to give any further consideration to the application.

35. Where a bilateral APA is being sought, HMRC will expect the business to continue to make relevant information available at the same time to each Administration involved, and in turn will itself keep the treaty partner informed about the progress of its examination of the APA request, will seek to discuss with the treaty partner key issues arising at the earliest opportunity and will keep the business informed about the progress of the bilateral process. Whilst the finalising of a bilateral agreement with a treaty partner is a government-to-government process, HMRC is generally prepared to participate in joint meetings involving the business and the other Administration(s) to assist in the exploration and evaluation of key factual issues.

Reaching agreement

36. The agreement between HMRC and the business will be made subject to its terms being observed. The terms will include:

a. a commitment from the business to demonstrate adherence to the agreed method for dealing with the transfer pricing issues during the term of the APA in the form of a regular compliance report (an "Annual Report") as required by Section 228 TIOPA 2010 and

b. the identification of Critical Assumptions bearing materially on the reliability of the method and which, if subject to change, may render the agreement invalid.

37. A sample "plain vanilla" agreement is included as an annex to this Statement (Annex 3). Normally the person responsible for signing the agreement on behalf of the business would be the person responsible for signing a tax return, subject to that person having authority within the multinational group to commit the group to the terms of the APA. The Annexes are available on the HMRC website.

38. HMRC aims to complete the APA process within 18-21 months from the date of the formal submission. It may well be possible to complete unilateral APAs much more quickly than that. This objective is dependent on the complexity of the case and, in the case of bilateral or multilateral applications, may be dependent on the working practice of the Administration(s) in the other country or countries. It is also, of course, dependent on co-operation from the applicant. HMRC may view significant and repeated delay on the part of the business as indicative of a lack of co-operation and may then terminate the APA process as a result.

39. HMRC expects the business to facilitate an efficient process by providing timeously all the information necessary to consider the application properly and reach agreement. This extends to the enterprise's co-operation in ensuring that the formal APA agreement and any associated procedural paperwork are finalised shortly after the finalisation of the transfer pricing method and/or, in a bilateral or multilateral process, the concluding of agreements with treaty partner(s).

40. If agreement on the terms of an APA cannot be reached with the business, HMRC will issue a formal statement recording the reasons. HMRC does not consider it has any obligation to continue discussion beyond the point at which it has determined that agreement cannot be reached.

41. A business may withdraw an APA request at any time before final agreement is reached.

APA monitoring and revoking APAs and penalties

42. The Annual Report will generally accompany the business' tax return. The report should be sent to the HMRC office responsible for the business' tax affairs.

43. The particular requirements of each report will be set out in the finalised agreement and will focus narrowly on the issue covered by the APA. The broad intention is that Annual Reports should demonstrate in a concise format whether the business has complied with the terms and conditions of the APA.

Nullifying and revoking APAs and penalties

44. In accordance with Section 225, TIOPA 2010, an APA may be revoked by HMRC in accordance with its terms, where the business does not comply with the terms and conditions of the agreement, or where the identified critical assumptions cease to be valid. In practice, when considering nullifying or cancelling a bilateral APA HMRC will consult with the business and with the Competent Authority of the treaty partner involved. In some cases, a change in the agreement may be possible – see also Paragraph 47 below.

45. Where false or misleading information is supplied fraudulently, or negligently, in connection with an application for, or in the process of monitoring, an APA, penalties may be applied, and the APA might be nullified (see Sections 226 and 227 TIOPA).

46. In accordance with existing appeal procedures, the business has the right to appeal against the amount of any additions to profits arising as a result of the revocation or cancellation of an APA.

Revising and renewing APAs

47. In some cases the APA may provide for modification of its terms in specific circumstances; for example, a particular agreement may provide that where there has been a change which makes the agreed methodology difficult to apply, but which does not go as far as to invalidate a critical assumption, the agreement may be modified with the consent of the parties to resolve that difficulty. In such cases the APA may be revised in accordance with Section 225, TIOPA 2010 after consultations between the business and HMRC and, in the case of bilateral agreements, the Competent Authority of the other country involved.

48. The business may request renewal of an APA ideally not later than six months before the expiry of its current term, but HMRC will not rule as out of time requests made before the end of the first chargeable period affected by the renewal or, in the case of bilateral cases, later, if the other Administration is prepared to allow further time. The renewal application should expressly consider any changes or anticipated changes in facts and circumstances since the existing agreement was reached, whether any amendments are required to the agreement on renewal as a result, and should demonstrate that the proposed methodology is, or is still, appropriate.

49. HMRC will conduct a review of the renewal application, taking into account whatever revisions to the existing APA are necessary and appropriate in the light of any changed facts and circumstances. Where it is agreed that the transfer pricing issues under consideration remain the same and the existing transfer pricing methodology can continue as before but with details updated to ensure continued adherence to the arm's length principle, the agreement will simply be amended and extended for a further term. Where, however, the transfer pricing issues have changed, or a different method is being proposed, the business will be required to make a fresh APA application. A fresh application may also be necessary in a bilateral context where the processes of the other Administration require that.

The guidance also had three useful Appendices which can be viewed on the HMRC website:

ANNEX 1 – INFORMATION TO SET OUT IN THE FORMAL APPLICATION

ANNEX 2 – A TYPICAL BILATERAL APA TIMELINE:

ANNEX 3 – SAMPLE AGREEMENT

HMRC Statement of Practice, 17/12/2010

Revenue and Customs Comrs v Maxwell and anor

Rule 2.38 of the Insolvency Rules 1986, SI 1986/1925, so far as material, provides: “(4) Votes are calculated according to the amount of a creditor's claim as at the date on which the company entered administration, less any payments that have been made to him after that date in respect of his claim and any adjustment by way of set-off in accordance with Rule 2.85 as if that Rule were applied on the date that the votes are counted. (5) A creditor shall not vote in respect of a debt for an unliquidated amount, or any debt whose value is not ascertained, except where the chairman agrees to put upon the debt an estimated minimum value for the purpose of entitlement to vote and admits the claim for that purpose.”

Rule 2.39 of the Insolvency Rules 1986, SI 1986/1925, so far as material, provides: “(1) At any creditors” meeting the chairman has power to admit or reject a creditor's claim for the purpose of his entitlement to vote; and the power is exercisable with respect to the whole or any part of the claim. (3) If the chairman is in doubt whether a claim should be admitted or rejected, he shall mark it as

objected to and allow the creditor to vote, subject to his vote being subsequently declared invalid if the objection to the claim is sustained.'

The taxpayer company was in the business of devising and implementing tax planning strategies. On 9 September 2009, two licensed insolvency practitioners and partners, were appointed as administrators of the company. The appointment was made out of court by the directors of the company (the directors). On the same day, the business and certain assets of the company were transferred pursuant to a so-called "pre-pack" sale agreement to DSL, which was controlled by the directors. The Revenue and Customs Commissioners (the Revenue) made claims for corporation tax in respect of six accounting periods. Three periods had been called "submitted periods" in the sense that the company had filed self-assessment returns for those before it went into administration. At the date of administration, the Revenue had written letters asking detailed questions about the submitted periods, which were unanswered by the company. On 17 September, the Revenue wrote to the company indicating its intention to amend self-assessments for the submitted periods. On 21 September, notices of amendment were issued, showing the net payable. In October, the administrators sent their report to creditors of the company with their proposals for achieving the purpose of the administration. The second respondent was chairman of the meeting on that date. The Revenue voted against the proposals, and the second respondent admitted its vote, but only to the extent of £1.5m. The proposals were carried. If the Revenue's vote had been admitted in the full amount claimed at the time, which was £9,336,814, the proposals would have been defeated. The Revenue issued an application, seeking to reverse or vary the second respondent's decision. The judge rejected the appeal, and upheld the second respondent's decision. The Revenue appealed.

Issues arose as to: (i) whether the amount of a creditor's claim was to be assessed under r 2.38(4) of the Insolvency Rules 1986, SI 1986/1925 (the Rules), as at the date of administration, or the date of the meeting; and (ii) whether the characterisation of a debt, namely whether or not it was "unliquidated" or "unascertained" for the purposes of r 2.38(5) of the Rules was to be assessed at the date of the administration, or the date of the meeting.

The plainly natural meaning or r 2.38(4) of the Rules was that the amount was to be assessed as at the date of the administration. Although linguistically it was just about possible to read the words "as at the date the company entered administration" as solely governing the immediately preceding word "claim". That plainly natural meaning was strongly supported by the reference in r 2.38(4) itself to deducting payments made after the company went into administration (see [48]–[49] of the judgment).

The chairman's powers of qualification under rr 2.39(1), (3) and 2.38(5) should have been exercised taking into account events that had occurred since the date of administration. Thus, if the debt was a claim for damages that had yet to be determined at the date of administration, and, before the meeting, damages had been assessed by the court and agreed, the debt would still be treated at the meeting as unliquidated and unascertainable, but, at any rate absent very unusual circumstances, it should be accorded a value equal to the assessed or agreed figure, arguably subject to a discount to allow for the fact that the valuation was to be as at the date of administration (see [54] of the judgment).

Reading rr 2.38(4) and (5) of the Rules together the debt should be characterised as at the date of administration. That was not merely based on logical consistency, but also on the language of the two paragraphs. The "estimated minimum value" of a debt in an unliquidated or unascertained amount under the latter paragraph became the "amount" of the debt under the former paragraph, and, that debt was to be assessed as at the date of administration (see [51] of the judgment).

In respect of the Revenue's claims for corporation tax, given that they had to be characterised as at the date the company went into administration the Revenue could not take advantage of any event that took place after 9 September 2009 to assist them in their contention that the claims for corporation tax were not unliquidated or unascertained. Any corporation tax claimed to be due, over and above the self-assessments, was not a liquidated ascertained sum, until the Revenue had issued notices of amendment. Accordingly, the Revenue's claims amounted to unliquidated or unascertained debts, and were to be assessed at the date on which the company went into administration. At the date on which the company went into administration it owed the Revenue substantial sums by way of corporation tax. On the evidence, the Revenue had made out a clear prima facie case to support its contention that the corporation tax they claimed was owing was

indeed due. A general denial of liability on the part of the administrators was insufficient to justify the judge being satisfied that he should reduce the amount claimed by the Revenue for the purposes of r 2.38(5) Accordingly, the judge ought to have accorded to the Revenue a level of votes that would have defeated the proposals as put to the meeting (see [56], [61], [65], [67], [69] of the judgment).

Another meeting of the creditors pursuant to r 2.34 of the Rules would be summoned by the administrators (see [70] of the judgment).

Court of Appeal, Civil Division Lord Neuberger of Abotsbury MR, Carnwath and Sullivan LJJ, 7 *December 2010*

Value Added Tax

Recovery of VAT on professional fees

In 2002, the taxpayer, Airtours, was experiencing financial difficulties. Price Waterhouse Coopers (PWC) were the company chosen by a number of financial institutions that had lent money to the taxpayer to submit proposals for advisory work required to provide an insight into what was happening at the taxpayer. The financial institutions, PWC and the taxpayer entered into a tripartite agreement whereby PWC was retained by the institutions to undertake a review of the taxpayer for the purpose of a decision regarding further lending to the taxpayer. The taxpayer was to be responsible for PWC's fees, expenses and disbursements in carrying out the work. In its relevant tax returns the taxpayer sought to deduct input tax from the fees paid to PWC pursuant to s 24 of the Value Added Tax Act 1994 (the Act). That section stated, inter alia, that "input tax" in relation to a taxable person, meant VAT on the supply to him of any goods and services being goods or services used or to be used for the purpose of any business carried on by him. The Revenue and Customs Commissioners (the Revenue) refused to allow the deduction of input tax. The taxpayer appealed to the First Tier tribunal (the tribunal). The tribunal allowed the taxpayer's appeal. In so doing, it considered the case of *Customs and Excise Commissioners v Redrow* [1999] STC 161 and construed the tripartite agreement as providing that the taxpayer wanted PWC's services for the purpose of its own business so that it could place the report before the institutions. The institutions were a party to the agreement because otherwise the PWC report would have carried less weight. In other words the services provided to the taxpayer were the services supplied by PWC rather than a service of the right to have PWC's services supplied to the institutions. The Revenue appealed.

It submitted that when the tripartite agreement as a whole was construed, it provided for PWC to supply services to the institutions and not to the taxpayer.

Where the person contracted for a service primarily for the benefit of a third party and paid for it, the question to be asked was "was something being done for him for which, in the course or furtherance of a business carried on by him, he has had to pay a consideration which has attracted VAT?" or "did he obtain anything at all used or to be used for the purposes of his business in return for that payment? "These questions were aimed at deciding whether the payer received something to be used for the purpose of its own business even though the main service was supplied for the benefit of a third party. The crucial factor was whether the taxpayer received something from the service in exchange for the payment. It had to receive something from the service other than a commercial benefit from entering into the agreement (see [16], [19] of the judgment)".

In the instant case, to answer the question whether something was done for the taxpayer by PWC or whether it received something of value from PWC, the terms of engagement of the tripartite agreement were not to be construed in a legalistic manner. When that was done, it could be seen that in substance the institutions were contracting with PWC for PWC's services. The taxpayer was a party to the agreement not to obtain any services from PWC for use in its business but to contract to pay PWC for supplying them to the institutions. Having the work done did not discharge any business obligation of the taxpayer or provide it with something to be used in its business. There was no business use made by the taxpayer of having PWC's services supplied to the institutions. In substance the institutions (and not the taxpayer) were contracting with PWC for the provision of services, and that PWC supplied those services to the institutions (and not to the taxpayer). In deciding otherwise the tribunal had made an error law (see [19], [20], [22] of the judgment).

R&C Commrs v Airtours Holidays Transport Ltd (2010)

Recovery of VAT on business entertaining

The office Christmas party

The cost for employees is classed as a staff welfare or motivational expense and input tax can be claimed while input tax recovery is denied for non-staff members.

The block in relation to business entertaining only applies if hospitality is provided free of charge. If non-staff guests are charged £5 per head to attend the function:

- Output tax will be due on the £5 charge (£5 x 7/47 = 75p)
- Input tax can be claimed on the costs relevant to the non-employee meals (£30 x 7/47 = £4.47).

So our overall cash position has been improved by both the guest charge and input tax saving.

Employees acting as hosts

Input tax cannot be claimed if the purpose of the employee attending an event is for him or her to act as host for the non-employees.

So to give an example, if a business wants to celebrate a successful trading year by taking its top ten customers to Ascot for a day at the races, with ten employees also attending to look after them, then all of the input tax on the cost of the event is blocked.

But what about the situation when an employee is away from his local area on business duties, meets a client in the evening for a meal, and pays the entire bill on his company credit card? It would be very harsh if the full input tax was blocked because he is entertaining a client – my view is that his meal should be treated as a ‘subsistence’ expense (a bit like his hotel bill) with the client’s meal treated as non-deductible entertainment.

Marketing and advertising costs

A common query relates to the input tax deduction on providing food and drink at trade shows or exhibitions that are designed to attract new customers and sell more products:

If the input tax relates to free food and drink for non-employees (excluding overseas customers) it is subject to the input tax block for business entertaining.

Overseas customers

HMRC recently confirmed that a business can now claim input tax on entertaining overseas customers, a policy change promoted by the ECJ case of *Danfoss and AstaZeneca* (C-371/07).

HMRC *Brief 44/10*

Input tax can be claimed on the cost of entertaining overseas customers, but not on any other overseas business contacts, e.g. suppliers, auditors, etc.

If the input tax is not classed as relevant to the ‘taxable’ supplies of the business, then a private use output tax charge will be payable by the business, which cancels out the input tax gain. So it must relate to, for example, business meetings rather than corporate events such as golf days and trips to sporting events.

To avoid a potential output tax charge, the entertainment provided (relevant to, say, business meetings rather than a good day at the races) must be ‘reasonable in scale and character’.

A business is entitled to claim past input tax for the last four years under the normal error correction procedures … but beware the output tax charge.

Partly business expenses

Imagine that I have bought a company aeroplane and I intend to use it as follows:

- company trips to business meetings (30% use);
- employees to freely use at weekends for private trips (20%); and

- days out for entertaining overseas customers – meal on the plane and sightseeing, etc. (50%).

Can I claim input tax on the cost of the plane?

One of the blocks that HMRC have imposed in Brief 44/10 is on 'corporate' events for overseas customers, so that would include the days out for our guests.

So there is a 50% input tax block straight away with regards to the use relating to overseas customers (based on use – although any calculation method that is 'fair and reasonable' can be made).

But what about the remaining VAT?

Until 31 December 2010, it would have been possible to claim all of the input tax back (the remaining 50% element) and then account for output tax on the 20% private use of the plane over a five-year period. This process is known as the Lennartz mechanism.

However, the only option available to our business if the aircraft is bought after 1 January 2011 is to carry out an input tax apportionment to block the private use at the time of the purchase: so that only the 30% input tax is claimed in relation to company business meetings.

The previous opportunity to use the Lennartz mechanism will no longer be available after 1 January 2011 in relation to the purchase of boats, aircraft, land and property.

Christmas gifts

John is a self-employed IT consultant who has enjoyed very good business this year with Smith, Smith and Smith Chartered Accountants. He has decided to give a £20 box of chocolates and a £10 bottle of wine to all 30 staff in the firm as Christmas gifts, including Mr Smith and the two other partners, Mr Smith and Mr Smith.

What is the input tax position?

The VAT rules on business gifts allow input tax to be reclaimed (and no output tax liability to be incurred) if the total cost of gifts given to the same person in any twelve-month period is less than £50, and they do not form part of a series of gifts (VATA 1994, Sch 4 para 5).

The good news is that following the ECJ case of *EMI Group Ltd v CCR* ([2010] STC 2609), it has been confirmed that the word 'person' relates to each employee in this example rather than Smith, Smith and Smith as one 'person', i.e. one business.

So John can claim input tax on the cost of his very expensive boxes of chocolates and bottles of wine, with no output tax liability to declare on his VAT return.

Summarised from an article by Neil Warren writing in Taxation

Lecture B634 (12.15 Minutes)

Update on bad debt relief

This article reviews the rules for claiming bad debt relief for VAT, and several recent cases which have highlighted problems with claims. The first section is an article which appeared recently in *Taxation* magazine covering the main rules and some of the recent cases. Four recent cases are considered in more detail at the end.

Taxation article (19 August 2010)

'The youth of today will never believe it', grumbled the four Yorkshiremen in the famous comedy sketch as they recalled the hardships of the past. The recent case of *GMAC UK plc* (TC00504) in the First Tier Tribunal was about the conditions for claiming VAT bad debt relief (BDR) 'back when I were a lad', which could be described as an insult added to injury – you had sold something to a customer for £1,000, had to pay £150 to Customs & Excise, then discovered that the customer wouldn't pay you anything and you had to jump through hoops to get the VAT back. The main onerous condition (until April 1989) was that the debtor had to be insolvent: it wasn't enough that it

was uneconomic to pursue the debt so you had given up chasing. Another, which was particularly relevant to a hire purchase company like GMAC, was that title in the goods had to have passed to the customer (supplies before 19 March 1997). Customs ignored a standard 'retention of title' clause in a sale contract, but an HP creditor could not claim BDR because the property only passed with the final payment.

GMAC persuaded the Tribunal that those ancient rules were more restrictive than the EU VAT Directive allowed. The original three-year time limit for repayment claims was introduced (badly) in 1996 as an attempt to limit the Exchequer's liability to traders who had suffered from the UK's imperfect implementation and application of the Directive, and HMRC fought a losing battle to defend that cap until 2008, when the House of Lords declared in *Fleming* that it could not be enforced without a transitional period allowing a last chance to claim.

Overpaid output tax and underclaimed input tax then had to be applied for by the end of a retrospective transitional period on 31 March 2009 – but BDR is subject to a different time limit, and there has never been a transitional period to allow last-gasp claims for breaches of EU law in this area. So it appears that GMAC – and perhaps some other similar businesses – will be able to dust off their old records and turn bad debts into hard cash.

One line of HMRC's defence in the recent case suggested a lack of commercial understanding. They argued that GMAC should not be allowed to enjoy a 'windfall' repayment. The Tribunal chairman doubted whether a bad debt claim could be any such thing – perhaps a recovery of output tax which had actually been paid by a customer might be, but surely BDR only reduces a loss.

Cold case review

The rules for BDR are set out in VATA 1994 s.36 and SI 1995/2518 regs.165-172. This article examines these rules in the context of past cases – learning from other people's mistakes is almost as good as learning from your own, but cheaper and less upsetting.

The main conditions which can be the subject of a dispute are set out in Table A.

Table A: VATA 1994 s.36(1)

The trader has supplied goods or services and has accounted for and paid VAT on the supply, the whole or any part of the consideration for the supply has been written off in his accounts as a bad debt, and a period of 6 months (beginning with the date of the supply) has elapsed.

Quick off the mark

The main condition for BDR is now that the customer has not paid within six months, which is a great deal more relaxed than the old insolvency requirement. There is a curious mismatch between s.36, which refers to claiming 6 months after the date of the supply, and reg.165A, which states that a claim cannot be made until 6 months have elapsed from the later of the due date for payment and the date of the supply. For normal trade terms of 30 days, then, the entitlement to relief comes about 7 months after the supply itself.

Where supplies are made close to the end of a quarter, a possible argument arises about the earliest return period in which a claim can be made. In Notice 700/18/02, HMRC are clear in their opinion that the trader cannot claim relief in a return for a period earlier than that in which the entitlement arises. See Example 1.

Example 1

Mr Sells prepares VAT returns to calendar quarters. He issued an invoice on 28 March 2010 to a customer who failed to pay. The due date for payment was 30 days after the invoice, 27 April.

There is an argument that s.36(1) validates the claim 6 months after the date of the supply, while reg.165A prevents it from being 'made' until 30 days later. If the VAT return for the quarter to 30 September 2010 is submitted after 27 October, it could be argued that all the conditions have been satisfied and the BDR claim can be included. However, this appears not to be HMRC's view: the claim would be accepted only on the return to 31 December 2010.

Written off

The law requires that the debt should be 'written off in the accounts as a bad debt', which seems clear enough: accounting entries are needed. However, the rule does not mean the trader has to give up chasing or give up hope. HMRC's manuals confirm that they are happy for the bad debts account

to be 'maintained outside the normal accounting system', which effectively means 'a note on the back of an envelope will do'. It is enough to keep a record to show that the claim relates to specific debts which satisfy the time constraint. The rules for the 'refunds for bad debts account' are shown in Table B.

Table B

The refunds for bad debt relief account must contain the following information:

- the outstanding amount to which the claim relates;
- the period in which the tax was accounted for and paid to HMRC;
- the amount of bad debt relief claimed;
- the period in which the claim was made;
- the amount of VAT chargeable on each supply;
- any payment received for the supply;
- the date and number of each invoice issued. If no invoice has been issued the supplier must detail the date, the name of the purchaser and the nature of the supply.

There are also detailed record-keeping requirements in SI 1995/2518 regs.168 and 169.

BDR can therefore be claimed as a routine way of improving cash flow where customers take over six months to pay. It is necessary to keep track of anyone who subsequently pays up so that the VAT can be given back to HMRC again. The claim is made with input tax in Box 4 of the VAT return, but is repaid in Box 1 if the debtor comes good.

Debit and credit

In the bad old days, because the insolvency condition was so hard to meet, some traders were tempted to recover the VAT on a bad debt by issuing a credit note and reversing the output tax instead. This did not work, because the credit note would not reflect a true change in the consideration for the supply (see one of the oldest decisions of the former VAT Tribunal, *Peter Cripwell & Associates* (VTD 660)). The main reason for attempting to circumvent BDR in this way has gone, but it still happens and it will still be corrected if HMRC notice it.

On the other hand, sometimes a debt is 'written off' because it is discovered that the payment was not really due. In that case a credit note is the correct treatment rather than BDR (*Cobojo Ltd* (VTD 4055)). A trader may use the same terminology and regard the situations as equally vexing, but they are quite different for VAT. See example 2.

Example 2

Briggs arranges an EIS share issue for four shareholders and charges each of them a percentage fee based on their income tax savings, which he expects to be 20% of the amount subscribed. One does not pay, explaining 'I can't afford it because I have no income'. After establishing that the shareholder had no tax liability in either the year of subscription or the previous year, Briggs has to issue a credit note, rather than claiming BDR: the agreed fee turns out to be nothing.

Payment by other means

One of those cases where I am tempted to shout 'you cannot be serious' (I would never have had sufficient decorum and restraint to be a tax barrister) is *AEG (UK) Ltd* (VTD 11428). The company attended a creditors' meeting and voted against a proposed voluntary arrangement in which preference shares were issued to suppliers. It subsequently claimed BDR, arguing that the shares were worthless and it hadn't wanted them in the first place. The Tribunal agreed with HMRC that the debt had been settled in full and no BDR was due.

In *Berck Ltd* (VTD 20051), a company owned 41.5% of one of its customers. As part of a management buy-out of the associate, it agreed to waive some of its debt in return for an 'exclusive supply agreement'. Again, the Tribunal agreed with HMRC that this was settlement for the debt and no BDR could be claimed.

Where a debt has been factored, the trader will receive less than the face value on which output tax was charged, but no bad debt claim is available. This was established in cases such as *Ciss Ltd* (VTD 18839). The discount charged by the factor is not a 'bad debt' but a finance cost.

Accounted for and paid

It seems a fair condition that a trader must have paid output tax to HMRC before claiming it back in Box 4 as BDR. The case of *Times Right Marketing Ltd* (VTD 20611) showed even that can be controversial. The company had not paid any of the Box 5 figure on the VAT return for the period in which the bad debts arose, so HMRC argued that it had not 'paid' anything that would entitle it to a BDR claim. The Tribunal agreed with the company that the offsetting of input tax in Box 4 against the output tax on the bad debt was sufficient 'payment' for this purpose. HMRC subsequently accepted this decision in Revenue & Customs Brief 18/09, stating that they would restrict a BDR claim by the amount of unpaid VAT on the relevant period's return, but they would not rule it out altogether.

Example 3

Guardian Left Ltd (GLL) entered £200,000 in Box 1 and £110,000 in Box 4 of the VAT return for March 2010. Only £20,000 of the £90,000 VAT due in Box 5 was paid by GLL, and customers owing £120,000 of VAT have not settled by September. A BDR claim is available for £70,000 (£120,000 less [£90,000 minus £20,000]).

It would be possible to arrange the numbers differently to achieve a more favourable result – perhaps the input tax and payment should cover the VAT on the bad debts completely, and the amount not paid to HMRC should relate only to 'good debts'. However, that is optimistic and would be hard to justify to the Tribunal.

A trader who uses the cash accounting scheme does not have to worry about BDR. Output tax does not have to be paid to HMRC until the customer has paid, so there is never any need to reclaim output tax on bad debts. However, someone using the cash turnover method for the Flat Rate Scheme can claim BDR if a customer doesn't pay within six months. This is because the trader would not pay the full 17.5% to HMRC if the customer did pay; so the trader still suffers a VAT loss when the customer fails to do so. See Example 4.

Example 4

Lottie uses the FRS with a flat rate of 8%. She makes a sale of £20,000 + VAT to a customer who fails to pay. If she does not use the cash turnover method, she will make a BDR claim of £3,500, even though she will not normally claim input tax in Box 4.

If she uses the cash turnover method, she can still claim the difference between the output tax (£3,500) and what she would have paid in Box 1 if the customer had settled the debt (8% of £23,500 = £1,880). She can therefore claim £1,620 in Box 4.

Too slow

I have sometimes wondered what happens if a trader does not specify a due date for paying invoices. That would be foolish, but it might happen between related businesses or friends. The problem would be that there would be no start date under reg.165A: six months could pass from the date of supply in accordance with s.36(1), but no claim would be permitted by the regulation until six months after the due date for payment.

As far as I know, no case has ever turned on this point. However, the recent case of *Resteel Trading Ltd* (TC00185) concerned the other side of this coin. The company made a sale to a connected business which had difficulty paying. Because of the relationship between the trades, the debt was not enforced; when finally the supplier realised that no money would ever be forthcoming, more than three years and six months had passed from the original due date (the limit is now four years and six months).

The company unsuccessfully argued that it had altered the original due date so the clock had not started to run against it. The Tribunal found that no formal agreement of this kind had ever been entered into, and the original date still stood. The claim was out of time.

It would have been possible for the supplier to claim BDR anyway after six months – it could still hope and expect its customer to pay. The customer should have reversed any claim to input tax it may have made in respect of the purchase at the same time under reg.172H, so there was nothing to be gained by the supplier delaying its claim.

Never never

A significant improvement to the BDR rules is illustrated by *Abbey National plc v C & E Commrs (No 3)*, Ch D 2005. A finance company's hire purchase instalment payments include VATable consideration for the goods and exempt interest. The tax point for the taxable part falls on delivery, while the interest is for a continuous supply of credit that runs throughout the period. The finance company will naturally regard payments in the early period as containing more interest and less principal – that is normal accounting.

In the period to which this case relates, the VAT regulations required instalments to be apportioned rateably between principal and interest. This meant that the bad debt for VAT purposes was more exempt and less taxable than it would be for accounting purposes. The High Court judge held that the rule was not irrational and was within the Commissioners' power to make. However, someone appears subsequently to have had a change of heart, because reg.170A was changed with effect from 1 September 2006 to allow a different method of apportionment. Although it is not immediately obvious in the regulation what the difference is, Business Brief 14/07 asserts that the purpose of the change was to allow commercial practice and recognised accounting methods determine the amount of the taxable consideration that was outstanding for the purposes of BDR.

As GMAC would have had the same problem as Abbey National, I wonder whether they are considering whether the old rules on apportionment of instalments might also have been contrary to the Directive. The judge's decision probably rules this out – even though an accountant, a financier and an economist would all have said the basis of the claim was logical, the lawyer has the final say on it.

It's probably looking too much on the bright side to say that 'bad debts aren't as bad as they used to be', but not all tax rules get worse. Sometimes, as GMAC are currently proving, the bad old rule should never have been applied – and those who suffered can make a claim.

Excessive conditions for bad debt relief

Before 1990, bad debt relief could only be claimed if the debtor was insolvent. The relaxation of the rules to allow a claim only on the basis of non-payment was a significant simplification, but it was not made retrospective. Until 1997, a claim could only be made if property in the goods supplied had passed to the customer, which was a problem for hire purchase companies (which would reserve title to the goods until they were paid for in full). Once again, when the rules were relaxed, this was not made retrospective.

GMAC claimed back a large amount of bad debt relief which it had been denied under the "old rules". The Tribunal had to consider in principle whether the UK's rules had been incompatible with EU law, and if they had, what the significance of the introduction of the cap was for this claim.

GMAC won a significant victory in an earlier case which allowed them to treat the recovery of cars surrendered by hire purchase customers both as an event allowing an adjustment of consideration under reg.38 SI 1995/2518 and also as a "repossession" which meant that the subsequent resale was outside the scope of VAT. The law was changed after that case so that a trader could not enjoy both these benefits on the same transaction, but the current claim would give rise to a double benefit in the same way. HMRC objected to the claim on the grounds that it would give rise to a windfall that was contrary to EU law.

The Tribunal considered the arguments and concluded that the UK's rules on bad debt relief had indeed imposed conditions that went beyond what was permitted in the Directive. Further, it did not appear that any "windfall" effect as alleged by HMRC was contrary to the Directive, if indeed the taxpayer would make a profit in a situation where there was a bad debt.

Lastly, the Tribunal ruled that the time-bar brought in for bad debt claims by s.39(5) FA 1997 was contrary to EU law because there was no transitional period; as a result, GMAC's current claim was not restricted by a time limit as argued by HMRC.

The decision was to allow GMAC's appeal in principle. During the course of the dispute GMAC had also put a figure on the claim, which was some £2.3m (presumably interest will be added, substantially increasing this figure).

First Tier Tribunal (TC00504): GMAC UK plc

Bad debt rules in detail

A company claimed bad debt relief on 12 March 2007 in respect of invoices dated 31 January and 6 March 2003. The amount claimed was over £44,000. The only issue was when payment was "due" on the invoices, which would determine whether the claim was made within the time limit of three years and six months from the due date for payment (reg.165A SI 1995/2518).

The general terms of business with the customer concerned specified that invoices were to be paid within 60 days, and invoices would cover all sales within the requisite month. This would set the time limit at 1 October and 5 November 2006, and the claims would be out of time. The customer went into liquidation on 13 February 2004. If that triggered the time limit, the claims were in time.

The company argued that there had been a variation of the original terms of trade in order to assist the customer to trade out of a cash flow problem. It had been documented in June 2003, but the officer of the company stated that this was simply a note of an agreement that had been reached earlier. He agreed with HMRC's counsel that it ought to have been more formally documented, but argued that such informality is normal in small companies.

The Tribunal chairman accepted the officer's evidence as reliable and honest, but interpreted the events differently. He did not believe that there had ever been a legally binding variation of the supply agreement; instead, the company had agreed to offer its customer "indulgence". The payments were still due, but enforcement action would not be taken. As a result, the bad debt relief time limits ran out when HMRC said they did.

First Tier Tribunal (TC00185): Resteel Trading Ltd

Debt was written off

A company claimed bad debt relief in its return for December 2005. Following an enquiry, HMRC assessed to disallow the claim in February 2008. The amount in dispute, after a number of revisions and adjustments, was £17,500. The company had been owed a total of £1,256,495 by a customer. It accepted payments in cash and in kind for £1m under a compromise agreement and wrote off the balance of £256,495. The company claimed that the amount of the total debt on which output tax had been accounted for was £576,494, or 45.9% of the total; it therefore claimed bad debt relief at 7/47 of 45.9% of £256,495.

HMRC argued that the debt had been settled, and no bad debt relief was due. According to them, the compromise agreement substituted the revised consideration in cash (£600,000) and kind (equipment valued at £400,000) for the original consideration so there was no entitlement to BDR, but also no entitlement to adjust the output tax originally paid.

The appellant's claim was based on art.11C(1) 6th Directive, which states:

"*In the case of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place, the taxable amount shall be reduced accordingly under conditions which shall be determined by the Member States.*
However, in the case of total or partial non-payment, Member States may derogate from this rule."

The company also argued that the total amount received by it was £1m, so there was an "outstanding amount" within s.36 VATA 1994 which was eligible for bad debt relief.

The Tribunal examined the precedent cases on consideration, revision of consideration, consideration in kind and bad debt relief. It concluded that it was not realistic to treat the compromise agreement as settling the debt in full: the consideration in kind (the equipment) had to be valued on a subjective basis, and the parties had clearly agreed between them that it was worth £400,000. As a result, the debt had only been settled to the extent of £1m, and the balance was outstanding and had been written off. The apportionment of the write-off between amounts on which VAT had been paid and amounts on which it had not was fair, and the appeal was allowed.

First Tier Tribunal (TC00627): CPG Logistics Ltd

Debt was partly paid

HMRC assessed a firm of solicitors to £322,843 in overclaimed bad debt relief over the three-year period to April 2007. The amount was later reduced to £216,862. The firm's practice was mainly concerned with acting for insurance companies in relation to claims. They are instructed by the company, but also have a professional responsibility to the insured person.

In 1985 the Law Society of Scotland publicised an agreement with HMRC that VAT-registered insurance claimants could claim as input tax the VAT incurred on legal fees in relation to claims, whether the instructions were given by the policyholder or by the insurer on his behalf. As a result, the insurer usually indemnifies the policyholder for a net-of-VAT amount, because that is the measure of the policyholder's loss. If the policyholder is partially or fully exempt, the loss will be greater and the insurer will have to pay more. The insurance company will not in any case be entitled to recover any of the input tax.

Following this, the firm changed its practice in relation to invoicing. It sent an invoice for the fee to the insurance company and an invoice for the VAT only to the policyholder. If this was not paid, the firm claimed bad debt relief. Each VAT return would have a schedule of the invoices which supported the bad debt claim for that quarter. HMRC visited the firm several times between 1985 and 2007 and did not raise any problem with this.

In June 2007, an officer visited the firm again and at last noticed that the firm was claiming the whole of the VAT on the VAT-only invoices, where 40/47 of the bill would have been paid by the insurance company. Notice 700/18 explains that, in this circumstance, only 7/47 of the VAT element would be eligible for relief. The original assessment was for 40/47 of the last three years' bad debt claims; this was subsequently reduced because the firm managed to recover significant sums from various parties and adjusted its VAT account accordingly.

The firm appealed, contending that the assessment would give rise to an unjustified windfall for HMRC. If the insured persons had paid the fees they would have been entitled to full input tax recovery, so HMRC were in fact in a neutral position following the bad debt claim. The firm also raised arguments based on the Human Rights Act and legitimate expectations (as previous visiting officers had never noticed a problem).

The Tribunal did not consider that these arguments were well-founded, and as a result did not have to conclude on whether it had jurisdiction to consider them. The earlier compliance visits could not be relied on as an assurance that everything was well with the VAT accounting; the 2007 visit had only identified the problem because the officer had noticed an increase in Box 4 and tried to find out what had caused it.

There was no doubt that the claims should have been restricted to 7/47 of the "outstanding amount", which took into account the payment of the net figure by the insurance company. The appeal was dismissed.

First Tier Tribunal (TC00662): Simpson & Marwick

Contributed by Mike Thexton

Lecture B635 (20.25 Minutes)