CONTENTS

PERSONAL TAX 2
Revised HMRC6 2
Changes to distributions under ESC C16 (Lecture P637 – 8.10 minutes) 3
Premiership footballers and tax avoidance (Lecture P638 – 8.44 minutes) 4
Expenses don't count towards minimum wage 4
Meaning of '30% of 'the loan capital and issued share capital' for EIS relief 5
Refund of Class 3 contributions following change in the law? 5
Contractor wins IR35 case 6

CAPITAL GAINS TAX 8
End of year CGT planning (*Lecture P639 – 8.57 minutes*) 8
London or Shropshire –which property qualifies for PPR? 9
Occupation to renovate, not as main residence 10
Base cost following husband to wife transfer 11
Rights issues and reorganisations: technical note (*Lecture P640 – 20.06 minutes)* 11

IHT AND TRUSTS 20
Buy to PET 20

ADMINISTRATION 21
CIS: Was failure to pay income tax a reasonable excuse? 21
Summary of new penalties to tackle offshore tax evasion 22
NPS – where are we now? (*Lecture B636 – 12.47 minutes*) 23
New CIS penalties (*Lecture B638 – 14.53 minutes*) 26
iXBRL – what you need to do now! (*Lecture B639 – 14.25 minutes*) 27

BUSINESS TAX 30
A partnership plan (*Lecture P636 – 14.16 minutes*) 30
No trade losses arose from the described activities 31
Cleaners: employed or self employed 31

CORPORATION TAX 33
Dividends checklist: Get the details right 33
Close investment –holding company (CIHC) (*Lecture B637 – 18.58 minutes*) 34

VALUE ADDED TAX 36
Simplification of the change in use provisions 36
Changes to the option to tax 36
Holidaymakers face end to VAT concessions 38
VAT and debt collection 39
Changes to Capital Goods Scheme: (*Lecture B640 – 32.50 minutes*) 40

Disclaimer
Reed Elsevier (UK) Limited takes every care when preparing this material. However, no responsibility can be accepted for any losses arising to any person acting or refraining from acting as a result of the material contained in these notes.

All rights reserved. No part of these notes may be reproduced or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of Reed Elsevier (UK) Limited

Personal Tax

Revised HMRC6

A revised version of HMRC6 was published by HMRC on 29 December 2010. Various amendments were made to the old one following discussions with the ExPat forum.

This new version should be used from now on (though HMRC say that the old version can be used to determine liabilities until 5 April 2011).

A summary of the main changes is given below.

"Legal force"

HMRC has removed the phrase, "It has no legal force" from the opening paragraph. I don't think this implies that HMRC think the new version has "legal force" as clearly it remains their interpretation of the law. However they will now rely on this published practice in front of the Courts.

The residence test.

The new version has been updated to take account of the Court judgments in the Robert Gaines-Cooper case.

From April 2011, HMRC will regard an individual as UK resident if either;

1. he spends 183 days a year in the UK (days still determined by the "midnight" rule); or
2. where days are less than 183, residence is determined by reference to criteria such as family ties, social ties, business ties and property ties.

The 91-day test here seems to have been removed.

The determining factor for those claiming non-residence status under the previous 91-day guidance would now seem to be "the purpose and pattern of your presence and your connections to the UK including the location of your family, your property and your work-life".

Actual numbers of days can't be completely ignored as HMRC concede that "how often and how long you are here" is a relevant issue, but there now seems to be no definite "line in the sand" as there was before with the 91-day test.

This must be worrying for those who make sure that visits back to the UK average out at just under 90 days a year. If such individuals have family in the UK, or own and use property in the UK or who do a lot of business in the UK, the new HMRC6 suggests that such people might be UK resident from 6 April 2011.

In terms of leaving the UK, the 91-day averaging test is now only mentioned under the full-time work abroad route (in para 8.5). It used to be in para 8.1 (leaving permanently or indefinitely). This suggests that (unless an individual is now leaving for employment reasons), keeping UK days below the 91-day averaging limit will not necessarily guarantee non-UK residence in HMRC's eyes.

One of the main reasons why Robert Gaines-Cooper lost his residence case was that HMRC successfully argued that RGC had never "left" the UK when he jetted off to the Seychelles in 1976. The Courts agreed that he never made a "definite break" from the UK (hence he remained UK resident).

The new HMRC6 contains some clarification of what is required for a taxpayer to break UK residence (see new para 8.2.1). Therefore if an individual leaves the UK (otherwise than for employment reasons), he must need to demonstrate a "distinct break" from the UK to be non-resident. Simply passing the 91 day return visits test won't be enough.

© Reed Elsevier (UK) Limited

New OR rule

There have been some subtle changes in the interpretation of the ordinary residence rules in section 7 (coming to the UK).

Previously where an individual came to the UK not knowing how long his visits would last, we would apply the 91 day average test for 4 years, and he would then be OR from the start of year 5.

This has now changed. If visits exceed 91 days on average for 3 years, he is OR from the start of year 4

No real changes have been made to chapters 4 or 5 of HMRC6 (domicile and the remittance basis).

Contributed by Steve Sanders, Tolley Tax Training

Changes to distributions under ESC C16 (Lecture P637 – 8.10 minutes)

ESC C16 was first introduced in 1985 and provided a simple and straightforward way for companies to be struck off, with the company assets – usually cash – being returned to the shareholders. Under this concession, CGT rather than income tax is payable and the costs of an expensive liquidation are avoided.

However, following the *Wilkinson* decision in the House of Lords, the Government decided to review all existing ESCs and, to the extent that they widen the law, they must either be withdrawn or else put onto a proper statutory footing.

In 2009, following an informal consultation which involved the CIOT and a number of other representative bodies, HMRC were advised that ESC C16 was a useful concession which should be retained.

Nowadays the main advantage of the concession is that, where entrepreneurs' relief is available, the tax cost of a dissolution will often be significantly lower than it would have been were an income tax charge to have been levied.

Unfortunately, there is a company law problem. If a company returns share capital without going through the process of a formal winding up, this is technically an unauthorised distribution and such assets can therefore be recovered by the Crown under the doctrine of bona vacantia.

In order to avoid this dilemma, the Treasury Solicitor published guidelines in 2008 ('Guidelines About The Distribution Of A Company's Share Capital'), under which the Treasury agreed that they would not pursue their right to receive any unauthorised distribution provided that the amount returned to the shareholders by way of share capital was not more than £4,000 – at the time, this was understood to be the average cost of a formal liquidation for a small company. However, the wording of ESC C16 was never modified nor was any mention made of the £4,000 limit in the Company Taxation Manual – see Paras CTM36205 and CTM36220.

In this connection, the Tax Faculty have commented:

'In practice, it would appear that HMRC have ignored the problem caused by the potential £4,000 limit and have been prepared to authorise company distributions under ESC C16 even though amounts in excess of £4,000 have been involved. The problem would only arise if the Treasury Solicitor became aware of the excess payment and chose to take action, but we are not aware that that has ever happened in practice.'

The new proposals will now limit the application of the replacement legislation to situations where the total funds available for distribution do not exceed £4,000. Previously, there was no limit. If the funds available exceed £4,000, income tax – and not CGT – will be payable. The deadline for comments on the draft legislation is 7 March 2011 and so any tax adviser with clients who are likely to be adversely affected should respond appropriately.

Contributed by Robert Jamieson

Premiership footballers and tax avoidance (Lecture P638 – 8.44 minutes)

In recent weeks, the newspapers have been full of stories about how more than 50 highly paid Premiership footballers have been able to avoid substantial amounts of income tax on their earnings. Wayne Rooney, who earns more than £10,000,000 a year from Manchester United, has apparently saved some £600,000 in tax over the last two years, while Manchester City's Gareth Batty, according to a report in 'The Sunday Times', has avoided paying tax of £135,000.

As a result, HMRC have said that they are now reviewing the legislation which has allowed so many top players to pay tax at just 28% on their earnings from image rights. Theo Walcott, Ashley Cole, Rio Ferdinand and Michael Owen are some of the well-known footballers who have launched their own companies to take image rights payments following the introduction of the 50% rate last year.

Under this arrangement, a player signs two contracts with his club – a normal player's contract and another contract covering royalties paid in respect of merchandising and image rights. Sums relating to this second contract are channelled into a separate company which is only liable to pay corporation tax at 28%. Players then typically take loans from this company and, with an official rate of 4% for assessing the benefit in kind, a 50% taxpayer is only liable to an effective 2% tax rate on that slice of his earnings. Wayne Rooney is reported to have taken £1,600,000 out of his image rights company to top up his salary from Manchester United.

A spokesman from HMRC confirmed:

Will the Government's wide-ranging new proposals on 'disguised remuneration' be able to catch this form of tax planning?

Contributed by Robert Jamieson

Expenses don't count towards minimum wage

The National Minimum Wage (Amendment) (No 2) Regulations 2010 came into force with effect for pay periods starting on or after 1 January 2011, meaning that travelling and subsistence expenses eligible for tax relief under ITEPA 2003, s 338 will not count when calculating national minimum wage (NMW) pay.

The Department for Business, Innovation and Skills and HMRC are aware that a number of travel schemes and umbrella business models are being marketed to claim to continue to provide savings for the employer and be compliant with the NMW from 1 January.

The offered savings include:

- paying subsistence expenses rather than travelling expenses;
- classifying workers as directors;
- holiday pay adjustments; and
- under-recording hours worked

The Revenue says these measures do not comply with the requirements of legislation for workers paid at, or close to, the NMW; the department intends to take appropriate action against firms that seek to circumvent legislation by using such schemes.

Meaning of '30% of 'the loan capital and issued share capital' for EIS relief

The company was a qualifying company for the purposes of the Enterprise Investment Scheme (EIS). It was incorporated in February 2000, and traded as an online wedding list gift business until it went into administration in August 2008.

The company was funded by the issue of subscriptions for shares, bank lending and loans from the directors, several individual and from another company. Both respondents held shares in the company and extended loans to the company.

The EIS was introduced to encourage investment by individuals in ordinary shares of unquoted companies. Relief from income tax was provided for investment in qualifying companies. For an individual to receive relief, he could not be 'connected' with the company in which he made an investment. The reason was to prevent EIS relief from being used by individuals to fund their personal companies or companies over which they had significant influence.

In March 2010, the First Tier Tribunal, Tax Chamber considered s 291(1) of The Income and Corporation Taxes Act 1998, which provided that an individual qualified for relief in respect of eligible shares for which he subscribed on his own behalf if he was not connected with the company at any time in the period beginning two years before the issue of the shares and ending three years after the issue date, which provided at, s 291B(1)(b), that an individual was connected with the issuing company if he directly or indirectly possessed or was entitled to acquire more than 30% of 'the loan capital and issued share capital of the company or any subsidiary'. The tribunal rejected the interpretation of the statutory framework governing EIS put forward by the Revenue. The Revenue appealed.

The Revenue submitted that the natural meaning of s 291B(1)(b) was a composite aggregated category.

The appeal would be allowed.

Having regard to the statutory context and purpose, the meaning of s 291B(1)(b) referred to a single composite category to which the 30% threshold would be applied (see [27] of the judgment).

Accordingly, the appeal would be allowed, and the tax asessments on taxpayers would be restored (see [30] of the judgment).

Revenue and Customs Commissioners v Taylor and another

04/01/2011

Refund of Class 3 contributions following change in the law?

Each of the taxpayers demanded that the Revenue refunded to them voluntary payments made by them to the Revenue. The payments had been for Class 3 National Insurance (NI) contributions. The issues arose because of the requirement for an entitlement to a full basic state retirement pension had changed in April 2010 from a full NI contribution record for at least 44 years for men or 39 years for women to 30 years. Each taxpayer had made more than the new required number of payments, but had made an additional payment or payments. Each taxpayer took the view that he or she had gained nothing from the contributions, and that they had paid them in error. They each asked for the sum to be refunded, which demand the Revenue refused. The first-tier tribunal, Tax Chamber, allowed two of the taxpayers' appeals, including B's, but dismissed the other eleven. Six of the unsuccessful taxpayers appealed to the Upper Tribunal. The Revenue appealed against the decision of the tribunal to allow B's payments to be refunded.

Consideration was given, inter alia, to Sch 3 to the Social Security contributions and Benefits Act 1992 (the 1992 Act), as amended by the Pensions Act 2007, s 1, and the Social Security (Contributions) Regulations 2001, SI 2001/1004 (the 2001 Regulations).

The appeals would be dismissed.

The definition of 'error' in r 52(9) of the 2001 Regulations was wide in terms of the scope of the term, but it was clear about its temporal effect. It could apply only to errors made at the time of payment, and then only to errors about some then-present or past matter. A future change of law,

as yet unannounced, could not be the cause of an 'error' within that temporal rule (see [24] of the judgment).

In the cases of the unsuccessful taxpayers, the tribunal had found that the payments had been made before any official announcement had been made of the rule change. Accordingly, those contributions could not be said to have been in error.

In relation to B's payments made after the rule change was announced, on the findings of the tribunal the payments had been made in ignorance of the proposed rule change. The payment had therefore been made 'in error' as to whether or not those payments were actually needed to make the contribution to earn the benefits for a state pension. Accordingly, the tribunal had been entitled to find that there had been present errors in relation to present facts, which fell within the meaning of 'error' within the r 52(9). Accordingly, the Revenue's appeal would be dismissed (see [22] and [34]-[35] of the judgment).

Bonner and others v Revenue and Customs Commissioners

13/01/2011

Contractor wins IR35 case

An engineer working on a contract basis for Airbus UK won his appeal against HMRC’s determination that he should be taxed as an employee under IR35 rules rather than as self-employed.

Following a hearing in Bristol in November, the First Tier Tribunal found in favour of MBF Design Services, the trading company operated by Mark Fitzpatrick. In February 2009, he appealed against HMRC’s decision that his employment status for the years 2001-07 fell within the terms of the Social Security Contributions (Intermediaries) Regulations 2000 and Income Tax (Pay As You Earn) Regulations 2003.

In April 2003 Airbus took on Fitzpatrick and his company MBF under a contract via intermediaries GED-Sitec and Morson Human Resources at an hourly rate that increased if he worked more than 35 hours in a week. The tribunal noted that the “request for services” to which the contract related included a seven-day notice period and a stipulation that substandard service or attendance would give Airbus a legitimate claim to withhold payment.

The tribunal notes that the contract agreed between Morson and Airbus named 53 individuals and appeared to be based on one normally used for the purchase of goods, with Fitzpatrick’s “quanity” indicated as 42,500 hours at his usual hourly rate.

The third contract between Morson and Airbus also included a clause setting out the client’s right to immediate cancellation of the contract, which was crucial to the tribunal’s decision that the terms were inconsistent with the mutuality of obligation that exists between employee and employer.

During the course of the hearing, one of HMRC’s witnesses, an Airbus design manager, admitted that his statement had been prepared by HMRC. While not doubting his honesty, the tribunal judges were not impressed with his evidence.

Noting that in the theoretical circumstances of a contract existing between MBF and Airbus, the judges ruled that the arrangements were typical of a contract for services. On site working was not a conclusive indicator of employment, the judges ruled. The nature of Fitzpatrick’s design work meant it had to be done computers at Airbus’s premises computers, in a similar way that electricians or plumbers frequently work on client sites.

Airbus’s right to cancel the contract without notice indicated a lack of mutuality of obligations, as did a series of occasions during computer failures where contractors were sent home without pay and employees had to remain on-site. Rather than seeking promotions, the contractor had to renegotiate with Airbus if he wanted better terms.

According to Matt Boddington from Accountax, who was MBF's lead representative at the hearing, the tribunal concluded there was insufficient control to demonstrate a contract of service. Any checking and approval of design work was an inevitable necessity of the project work MBF had undertaken.

"This is a significant bloody nose for HMRC and highlights that if parties arrange their affairs correctly and if these arrangements are an accurate reflection of reality then the IR35 legislation simply will not bite," said Boddington.

AccountingWeb, 28 January 2011

Capital Gains Tax

End of year CGT planning (*Lecture P639 – 8.57 minutes*)

With CGT at a rate of 10%, 18% or 28%, it is vital that all possible means of reducing the CGT rate are fully explored.

There are a number of opportunities, all of which are only realistic if circumstances permit.

The annual exemption

A married couple or civil partners have the use of two annual exemptions.

This is now worth £5,656 per annum to them (£10,100 x 2 @ 28%).

It is therefore even more important to consider creating disposals by 5 April 2011.

Disposals between them are still on a no gain: no loss basis.

Bed & breakfast is possible, with the spouse/civil partner making the repurchase.

Pay pension contributions and/or make charitable donations

For chargeable gains arising from 23 June 2010 the rate of CGT is 28% if and to the extent that the total of income plus gains exceeds the basic rate band of £37,400 for 2010/11.

If circumstances allow, the rate of CGT can effectively be reduced by paying pension contributions and/or making gift aid donations by 5 April 2011.

Illustration

Joe has taxable income in 2010/11 of £40,000. Gain made of £16,000 in excess of annual exemption, on an investment.

Ordinarily the gain of £16,000 is taxed at 28% = £2,880.

If Joe pays £7,000 gross as a personal pension contribution by 5 April 2011 he will obtain tax relief as under:

£40,000 - £37,400 = £2,600 @ 40%	1,040
£4,400 @ 20%	880
Total income tax relief	£1,920

Reduction in CGT = £4,400 @ 10% = £440

Total tax relief on £7,000 is £2,360 = 33.71%

Creating a business asset for entrepreneurs' relief

This is not specifically related to the end of the tax year, and it can apply to ensure that the client makes a profit on a business asset which qualifies for CGT entrepreneurs' relief. Then, he will only pay CGT at a rate of 10% subject to the new lifetime limit of £5 million of gains. If on the other hand the asset does not qualify he is likely to pay CGT at 28%. Clearly any realistic planning moves which could ensure tax at 10% have got to be seriously considered.

If the plan is to sell a property which is not the main residence, there will be CGT to pay – probably at 28%. Consider, if realistic, letting the property for at least the 12 months up to the sale date, with the lettings coming within the furnished holiday lettings regime. That qualifies the owner for entrepreneurs' relief with CGT reduced to only 10%, despite the fact that for most of the time the property was perhaps let on a long-term basis or empty. There is no reduction in the amount of entrepreneurs' relief in such a situation as the only requirement is for the property to qualify by reference to usage in at least the last 12 months' of ownership.

Contributed by Gerry Hart

London or Shropshire –which property qualifies for PPR?

The following was published on the Taxation Forum in January 2011:

The issue

On the sale of a property, a married couple, who own two properties,want to know the position re PPR given that they live apart but continue to holiday together.

The scenario

Using funds provided wholly by Mrs P, a matrimonial home was purchased in London in the joint names of Mr and Mrs P in June 1966 following their marriage in 1964.

In June 1990, Mr P started a business in Shropshire, purchased a house there in his own name and started living there while Mrs P remained, with the children, living in London. She now lives there alone.

No main residence election has been made by either party, although Mr P puts the Shropshire address on his HMRC returns.

Although still married, they live in separate properties but with no separation agreement and continue to holiday together.

Mrs P wishes to sell the London property in June 2011 and Mr P has indicated that the proceeds should be retained by her.

Summary of replies

Normally, a married couple can only have one main residence between them, so long as they are *living together*.

Although Mr and Mrs P are not technically living together, they may well be classed as such by HMRC as they are not separated under a court order or deed, or separated in circumstances which make a permanent separation likely.

In essence, the marriage needs to have broken down before HMRC will agree that a couple are separated. As Mr and Mrs P still holiday together, there are good grounds to conclude that they will be treated as living together by HMRC.

As a result, they are only entitled to one main residence between them under TCGA 1992, s 222(6).

Main residence

When Mr P bought the Shropshire property in June 1990 and moved there to start his business, he could not have made an election to treat this property as his main residence as this would have required Mrs P to elect the property as her main residence also. As Mrs P had never actually lived in the property, she would not have been entitled to make this election.

In the absence of such an election, HMRC are likely to take the view that Mr P’s main residence is the London home.

Sale of the London home

As Mr P still legally owns half of the London property, he is liable for capital gains tax on the gain that arises on the proposed sale in June 2011.

Whether he is treated as living there or not, he will be entitled to PPR for the period that he lived in the property as his main residnece (up to June 1990) as well as the last 36 months of ownership. The balance of the gain will be liable to CGT at his relevant rate (be it 18% or 28%).

As Mrs P has remained in the property since purchase, her gain will be fully covered by the main residence exemption.

Advice

As Mr P would like Mrs P to retain the proceeds from sale anyway, it would be sensible for Mr P to make a no gain/no loss spousal transfer to Mrs P prior to the sale of the property. Mrs P would then acquire the other half of the property at Mr P’s cost, the amount of which would be largely irrelevant, as the total gain would be covered by her accumulated main residence exemption.

Consideration should be given to any stamp duty land tax that may arise on the transfer which would technically be payable by Mrs P as 'purchaser'; Mr P may need to offer to cover this amount, but this would almost certainly be preferable to paying capital gains tax on his share of the gain.

Mrs P's new property

The treatment here depends on whether the couple are treated as living together for CGT purpsoes or not.

If they are treated as living apart, the situation is straight forward. Each can claim main residence relief on their own property that they will be living in as there main residence.

However, if they are treated as still living together, which at present seems likely, main residence relief is only available on one property. The question is , which one?

Where a main residence election by a married couple affects both parties, the claim must be made jointly with both signatures. At this point, neither party will have lived at the other one's residence, meaning that the HMRC default of a main residence being a question of fact becomes a problem.

On first glance, it seems that neither Mr P nor Mrs P is able to claim a main residence for the purposes of the main residence exemption. Immediately, this seems to be an unfair position to be in as the couple are being penalised for not living together.

If, however, there is a period of time between the disposal of the London property and the purchase of a new one by Mrs P then technically she is without a main residence. Her main residence would then become her husband's by default (i.e. the Shropshire pad), which would leave the subsequent purchase of a property in her own name exposed to future capital gains tax on disposal.

One option may be to own both properties jointly, so that both Mr P and Mrs P have an interest in each. As a result, an eventual sale of the elected main residence (which should obviously be the one standing at the biggest gain) would at least attract some relief for each party.

Occupation to renovate, not as main residence

The taxpayer was divorced in 1997 and soon afterwards learned that he would be made redundant in 1999.

As he believed he would be unable to meet his financial commitments, he decided to sell the former matrimonial home and buy another property. He sold the property in November 1998 and moved in with his brother.

However, he gave HMRC the address of his secretary, with whom he was having a relationship.

In November 1999, having been made redundant, the taxpayer bought a property for £47,000. It required a lot of renovation which the taxpayer did himself. From July 2000, he let the property to students. He began full-time employment in September 2003, and sold the property two years later. He claimed only or main residence relief for the period between November 1999 and September 2000 on the gain.

The taxpayer said that he lived at the property while he was renovating it, although he had claimed exemption from council tax for that period. The electricity and water were connected but the gas was not. HMRC refused his claim so the taxpayer appealed.

The First-tier Tribunal said that it was likely that the taxpayer did spent some time occupying the property while he was working on it, but thought he did not occupy it as his home. It had no cooking facilities and the gas was switched off for much of the time meaning that there was no hot water.

Furthermore, the property was being developed with a view to letting rather than the taxpayer's personal occupation. The tribunal concluded that, to the extent that the taxpayer stayed at the property, this was for the purpose of renovating it rather than occupying it as his home.

The taxpayer's appeal was dismissed.

Malcolm Springthorpe (TC832)

Base cost following husband to wife transfer

The taxpayer's husband inherited a property with a probate value of £40,000 in 1986. In November 2005, he transferred a half share in the property to his wife (the appellant) by way of gift. The value of the whole property at that time was £450,000.

In April 2006, the property was sold and the appellant's share was £232,500.

In her tax return, the appellant reported the gain, using the 2005 value as the acquisition cost. HMRC disputed this figure, saying that the 1986 value should be used.

This was on the basis that under TCGA 1992, s 58, a transfer between spouses is on a no gain no loss basis and therefore the husband's base cost should be used in computing her capital gain.

The taxpayer appealed.

The First-tier Tribunal, finding for HMRC, said that the appellant had made 'an honest mistake' in her capital gains tax computation.

Section 58 was clear that when there is a transfer between husband and wife, the transferee takes on the acquisition cost of the transferor. The gain on transfer is deferred until the transferee disposes of the asset.

The taxpayer's appeal was dismissed.

The appeal also concerned a statement of account incorrectly issued by HMRC for the year in question, shortly after opening the enquiry, which showed that the taxpayer had nothing further to pay.

The tribunal said this confused the taxpayer, who was elderly and in poor health, but if she had read the accompanying notice, she would have known it was not a closure notice.

However, under the circumstances, the tribunal hoped HMRC would be 'merciful' with regard to a surcharge.

Ann Godfrey (TC852)

Rights issues and reorganisations: technical note *(Lecture P640 – 20.06 minutes)*

Since 6 April 2008, the records of a shareholding's cost for CGT have become much simpler – in most cases, if there are not sales and purchases in a short period, a sale can be matched with a single pooled holding at average cost. For example, if a shareholder has accumulated 20,000 shares in XYZ plc at a total cost of £43,264, and sells 5,000 shares, it is clear that the disposal uses a quarter of the base cost - £10,816.

This article considers some of the situations where there are still complications, in particular:

- the sale of rights nil paid, where the shareholder has sold something but still owns the same number of shares;
- takeovers and reorganisations, where the shareholder starts with 20,000 shares in XYZ plc which cost £43,264, and ends up with different pieces of paper which may be chargeable to CGT or may be exempt, and may also have some cash as well.

Adjusting the holding

There are a number of different investment transactions in which the investor:

- starts with some shares;
- ends up with different "paper" s based on the original holding but is different from it, and either:

  - puts in some more cash; or

  - receives some cash.

Examples are:

- rights issue: start with cum-rights shares, end up with ex-rights shares on which more money has been put in.
- sale of rights nil paid: start with cum-rights shares, end up with ex-rights shares and some cash.
- takeover: start with shares in Oneco plc, end up with shares or other securities in Twoco plc, possibly with some cash as well.

All these situations are treated by the CGT legislation as "reorganisations". The basic principles of reorganisations are as follows:

- where the starting and finishing positions only involve chargeable "paper", there is usually no "trigger event" for CGT, and the base cost of the original holding is simply transferred to the new holding.
- where further cash is added, there is an increase in base cost – but there is no separate, current acquisition for identification purposes, because the new shares (e.g. on a rights issue) are only acquired because of the original holding.
- where some cash or CGT-exempt "paper" is received, there is a disposal, but not a disposal of the whole – the original base cost has to be divided between what is retained and what is sold, and the cost that is "used up" in the disposal is set against the proceeds to determine the currently chargeable gain.
- where several different elements of consideration are received, the base cost of the original holding has to be split between the different things that have resulted from the transaction. This is always done in proportion to the values of the different elements of consideration on the date of the transaction, i.e. the "first day dealing prices" for securities, and the actual amount of any cash.

There are then reliefs which avoid an immediate charge to tax on:

- small amounts of cash – up to 5% of the current value of the whole holding;
- CGT-exempt paper – the gain is not charged until it is cashed in or sold.

Bonus and rights issues

Bonus (also called scrip, "cap" or capitalisation) and rights issues are treated as an adjustment to the holding to which it relates, rather than a separate acquisition. This means that for identification purposes, bonus and rights shares are added to each relevant part of an existing holding – usually, since April 2008, the s.104 holding.

After 5 April 2008, it no longer makes any difference whether shares are acquired in a rights or a bonus issue, except where the "same day" or "next 30 days" would otherwise apply. All acquisitions will be pooled.

Shares are not identified with each other if they have a different SEDOL number. This will generally be the case with cum-rights and ex-rights shares. This means that someone who sells some of a shareholding cum rights, shortly before taking up some rights on the rest of the shareholding, will not normally have to identify the sold shares with the bought shares even if there are fewer than 31 days between the transactions.

This is not the same as a sale of rights nil paid which is described in the following section.

Sale of rights "nil paid"

If rights shares are sold "nil paid", there is a "capital sum derived from an asset", and a capital gain is calculated. This also applies to any capital payment made by the company if the rights are not exercised ("lapsed rights payments").

The normal identification rules are followed to see from where the rights arose. The cost of these holdings is then partly used up in the disposal. The problem is that no shares have been disposed of – it is not possible to "take 10% of the cost because 10% of the shares by number have been sold".

The applicable cost is "A over A plus B" times the cost, where:

A is the proceeds of the sale;

B is the ex rights value of the shares, i.e. the value of what has been retained after the issue.

The law suggests that "A" and "B" should be measured on the date of the disposal, i.e. the date that the rights are sold nil paid. In practice, HMRC appear to accept a "standard" apportionment based on the first day prices of the nil paid rights and the ex rights shares, available in published information services. Subsequent movements in the relative values are unlikely to make a significant difference, and a fund manager with a large number of clients will find it impractical to calculate different proportions on an individual basis.

Example

Vicky owned 10,000 shares in JKL plc. They cost £35,000 in 1989. A 1 for 2 rights issue is declared in 2010. She sells her rights "nil paid" for £2 per rights share. The ex rights price of the shares is £6 per share.

The fraction of cost that is used is "A over A plus B":

A is £2 x 5,000 = £10,000; B is £6 x 10,000 = £60,000

the proportion is 10,000/(10,000 + 60,000) = 14.286%

Alternatively, the information service may give a proportion, which will then be used regardless of the actual "A" and "B".

The gains computation is therefore:

Proceeds	10,000
Fraction of cost: 14.286% x 35,000	– 5,000
Chargeable gain	£5,000

The cost carried forward is £30,000 (£35,000 – £5,000).

Sale of rights "nil paid" – "small proceeds"

Where the proceeds of the rights sale are "small", a different treatment applies. According to HMRC, "small" means that "A" is no more than 5% of "A plus B" in the above computation, or else is not more than £3,000 (Tax Bulletin, February 1997). HMRC are also willing to discuss the taxpayer's assertion that other figures could be "small", but will always accept the 5%/£3,000 limits.

Commoner relief

If the proceeds are small and are less than the whole cost of the shares, the small proceeds are automatically:

- not charged to CGT at this time;
- deducted instead from the base cost to be carried forward.

The result is a smaller base cost carried forward, so a larger gain in the future. Although the law states that this happens automatically, HMRC will not apply this rule to someone who does not want it (published Revenue Interpretation 34).

For CGT (where indexation is irrelevant), the proceeds are simply deducted from the pool.

Example

Bill has owned 2,000 shares in PQR plc since 1980. In March 1982, they were worth £6,000 (more than their original cost). In March 1986, Bill sold some rights nil paid, and received "small proceeds" of £1,000. In May 2010, he sells the whole shareholding for £15,000.

Proceeds 2010		15,000
Market value 31 March 1982	6,000	
less: rights proceeds March 1986	– 1,000	– 5,000
Chargeable gain		£10,000

Rarer relief

If "A" is "small", but is larger than the whole cost of the shares, a different relief applies. This must be rare, because it implies that the whole cost is less than 5% of the current value – the share must have grown more than 20 times since purchase. It operates as follows:

- the whole cost can be deducted from the proceeds, rather than "A over A plus B";
- there is therefore a smaller gain now;
- there is then no cost to carry forward, and any subsequent sale proceeds will be all gain.

Example

Tracey bought 10,000 EFG plc shares for £2,000 in 1984. In 2010 a 1 for 2 rights issue is declared, and Tracey sells her rights to 5,000 new shares for £1 per share. The ex rights price of the shares is £10.

The "A over A plus B" computation would set 4.762% (£5,000/£105,000) of the pool cost (£2,000) against the proceeds of £5,000, and the gain would be £4,905 (£5,000 – £95). Cost carried forward would be £1,905.

If Tracey wants the "small proceeds" treatment, she would have the following computation:

Proceeds	5,000
Acquisition cost	– 2,000
Chargeable gain	£3,000

She would have no base cost carried forward – any subsequent sales would be chargeable on the whole proceeds as a capital gain.

British Telecom: practical example

British Telecom made a rights issue in 2001/02. The information service shows the following:

Rts 3 for 10 @ 300p p.s. payable June 15 xr 21.5.01

This means that the rights issue offer was 3 shares for every 10 already held; the new investment was £3 for every new share, so £9 would be paid up for every 10 old shares (giving 13 new shares); this was to be paid on June 15 2001, but the offer was made to those who were registered as shareholders on 21 May 2001. After that date, those to whom the offer was made could sell their rights "nil paid" (see the next section).

Lapsed rights: payment 129.14p per new share, cheques posted 2.7.01

If someone did not take up their rights, the rights were offered to others, who would therefore buy up shares for 300p plus whatever they paid for the rights. The proceeds of this sale belong to the person who had the rights but did not take them up. This is the same as a "sale of rights nil paid", except that the company has carried out the transactions automatically on behalf of the shareholders who have failed to do so. In a company as widely held as BT, there will be many small shareholders who would not realise what they were supposed to do with the rights letters, so it is "fair" to them to give them some of the benefit of the rights issue without them having to take any action.

Adjustment: Unit (ord + 90p) x 0.76923; Hldg: + 90p p.s.

Each old share gives rise to 3/10 of a rights share, which costs 3/10 of 300p, or 90p. A person who takes up all the rights will therefore increase the cost of the holding by 90p for every share held (less small proceeds from the sale of fractions, if the rights are not for an exact number of shares). The "unit" adjustment converts the increased value into a "per share" figure: the number of shares has been increased by a factor of 1.3, and 0.76923 is the inverse of 1.3. So if 10 old shares cost 400p each, the 13 new shares would have an average cost of (400p + 90p) x 0.76923 = 376.92p.

This can be proved by checking that (400p x 10) + (3 x 300p) = 13 x 376.92p, which it does.

MV 21.5.01 New Ord 157.375p pm nil paid; ord ex price 457.875p

These figures are used for calculating gains on disposals of rights nil paid. The ordinary shares "ex rights" (i.e. fully paid up, but without the right to subscribe for additional shares at 300p, because the ex rights date has passed) were worth 457.875p each; the rights on their own were worth almost exactly 300p less than this – slightly less, because of the transaction costs involved in taking up the rights issue (i.e. buying the share itself is "easier", and that's worth 0.5p).

The "A over A plus B" percentage for disposal of rights nil paid is usually calculated by taking the first day dealing prices in the information service, rather than the "strictly correct" actual figures for amounts received and market value of the remainder on the day the sale takes place. In this case, the information services gives:

(3 x 157.375p)/[(3 x 157.375p) + (10 x 457.875p)] = 9.347%

Someone who received a lapsed rights payment would set 9.347% of their base cost against the 129.14p received in respect of each share.

Example

BT shares were worth about 990p on 14 February 2000. Suppose an individual purchased 10,000 shares for £99,000 on that date, and then did not take up the rights issue.

After the issue, the shareholder receives 10,000 x 3/10 x 129.14p = £3,874.

The base cost used up is 9.347% x £99,000 = £9,254.

The allowable loss crystallised is £5,380.

Remember that the use of the first day dealing prices to calculate "A over A plus B" is a simplification, and it is not strictly accurate or in accordance with the law. It is clear that the value of BT shares fell substantially between the XR date and the payment of the lapsed rights – by something like 28p. If the price of the shares themselves fell by about the same amount as the rights, the revised calculation would be:

(3 x 129.14p)/[(3 x 129.14p) + (10 x 429.875p)] = 8.267%

This would give rise to a slightly smaller loss, because the percentage of the base cost used up would be lower. It would mean a higher base cost would be carried forward to the future.

It appears open to the shareholder to use an 'exact' calculation instead of the simplification, but you would then have to research the figures for the value of the shares on the day you disposed of the rights. The only figure in the information service is the value on the XR date.

Sale nil paid to take up entitlement

A particular issue arises when someone sells some rights nil paid in order to take up an entitlement to the rest of their rights. Indexation and taper relief would have been a factor in the calculations that follow, but the principles are still relevant – so the abolished reliefs have been glossed over in the example.

Example

An individual owned 30,000 BT shares. They had a cost of £120,000.

When the share issue was announced, the individual had the right to take up 9,000 new shares at a total cost of £27,000. However, she decided instead to sell some rights nil paid in order to generate the cash to take up the rest.

Suppose that the nil paid price was 150p on the day she took this decision. For every 2 rights sold nil paid, she could take up 1. So she sold 6,000 rights nil paid, for proceeds of £9,000, and took up 3,000, at a cost of £9,000.

The disposal takes place before the acquisition. As the rights to 2/3 of the pool have been sold, the logical computation looks like this:

Proceeds of sale of 6,000 rights:	£9,000
9.347% (from information service) x £120,000 x 2/3	£7,478
Gain	£1,522

Alternatively, HMRC could be asked for the "small part disposal proceeds" relief, even though the percentage is higher than 5%. As the rights sold relate to 2/3 of the pool, it could be argued that the percentage should be 2/3 x 9.347%, which is only just over 5%.

The cost carried forward would then be:

brought forward: 30,000 shares: £120,000 – £9,000	£111,000
rights issue: 3,000 shares	£9,000
total: 33,000 shares	£120,000

Reorganisations and takeovers

A reorganisation of share capital involves exchanging one sort of security for another. A takeover often involves exchanging securities in one company for securities in another. In both cases, the shareholder no longer owns the first securities (i.e. there appears to be a disposal), but there may be no receipt of cash.

Chargeable consideration: shares, non-QCB loan stock

Where the new securities are chargeable to CGT, the law offers the following relief, as long as the transactions are not part of a scheme to avoid tax:

- there will be no disposal of the first securities…
- …and the new securities will be treated as if they were the old securities for all purposes.

Reorganisations include bonus issues or rights issues where the new shares are of a different class to the previous ones. Two holdings arise, and the cost of the original holding must be apportioned between them.

A "clearance" will normally be applied for from HMRC in advance of the reorganisation to confirm that the above rules will apply. If all the facts are presented to HMRC, and they accept that the arrangement is not part of a scheme to avoid tax, they will commit themselves not to question it again afterwards.

Exempt consideration: QCBs

The treatment is slightly different if the consideration is in CGT exempt securities such as "qualifying corporate bonds". There will be no gain or loss on the sale of these, so there is no point in them having a base cost to carry forward. On the other hand, the gain to the date of exchange was a gain on a chargeable asset, so it should be taxed.

For these reasons:

- the exchange is treated as a disposal, and the gain to the date of exchange is calculated on the market value of the consideration received;
- that gain is held over until the exempt securities are disposed of.

Loan notes are a very common device to allow "bed and breakfasting in arrears", as explained below in relation to Scottish Widows.

Consideration in cash and securities

If the consideration for the takeover is partly in cash, part of the gain to date is usually charged immediately. Different elements of the consideration are valued, and the base cost of the original assets (or MV82 if relevant) is apportioned to each item. Then base cost:

- apportioned to consideration in shares is carried forward as the base cost of the shares;
- apportioned to QCBs is used to calculate the gain to date, which is frozen;
- apportioned to cash is used to calculate the gain to date, which is charged.

Theoretical example

Alfred bought 1,000 EFD plc shares in 1988. In June 2010, the cost in the pool is £7,500. EFD plc is taken over by JKL plc, and Alfred receives consideration as follows:

	Consideration	Base cost	Gain
JKL plc shares worth	15,000	3,750	N/A
JKL plc loan stock worth	10,000	2,500	7,500
Cash	5,000	1,250	3,750

The base cost is apportioned in the ratio 15:10:5; the gain on the cash element is charged immediately, and the gain on the loan stock element is carried forward until the loan stock is disposed of.

The base cost of the JKL plc shares carried forward is £3,750 (15/30 x £7,500).

If the cash element is "small" (i.e. up to 5% of the total consideration), the treatment is the same as that for "small rights proceeds" described above:

- if the cash is larger than the whole of the base cost, the shareholder can claim to use the whole cost on this disposal, and carry forward no base cost for future disposals;
- if the cash is smaller than the whole of the base cost, the small cash is automatically deducted from the cost carried forward for shares – and added to the frozen gain on loan stock.

Even more theoretical example

Annie bought 1,000 QWE plc shares in 1988. In June 2010, the cost in the pool is £7,500. QWE plc is taken over by HJK plc, and Annie receives consideration as follows:

	Consideration	Base cost	Cash
HJK plc shares worth	20,000	5,000	800
HJK plc loan stock worth	10,000	2,500	400
Cash	1,200		

The base cost is apportioned in the ratio 20:10 (because the cash is ignored, being only 3.8% of the total). The frozen gain is £7,900, carried forward until the loan stock is disposed of.

The base cost of the JKL plc shares is £4,200 (20/30 x 7,500 – 800).

Note that a loan stock which is not a QCB and is chargeable to CGT (i.e. is a "debt on a security") is treated as a share for CGT purposes, even if the value is less likely to appreciate in the same way as a share. So, on a "paper-for-paper" takeover:

- a person receiving QCBs will calculate the gain accrued to date, and "freeze" it against the QCB – that gain will be chargeable on a subsequent disposal, but any gain or loss arising after the exchange will be exempt;
- a person receiving loan stock which is not a QCB will carry over the original base cost, and will still be chargeable to CGT or entitled to allowable losses using that cost if the value rises or falls subsequent to the exchange.

Insult and injury

A problem arises if the exempt loan stock becomes worthless. If the company is liquidated, the loan stock is treated as "disposed of". This triggers the "frozen gain" set out in the previous example; but the loss on the loan stock (in Annie's case, £10,000 – the reduction in its market value since the exchange) is exempt and cannot even reduce the related gain. The stockholders may have to pay tax on £7,900, when they have actually lost all their money.

HM Revenue & Customs recognise that this is somewhat unfair, and have approved a way of getting out of it:

- before the liquidation or the receipt of any proceeds, the worthless bonds are given to charity;
- the gift to charity does not trigger a charge on the "frozen gain";
- the charity does not suffer any tax on the liquidation, because it is an exempt body.

Real life examples

Example – chargeable consideration

United Business Media plc was taken over by a Jersey incorporated company which is tax resident in Eire. On 1 July 2008 the takeover was completed by the issue of 1 new ordinary 33.8068p share for every 1 old ordinary 3371/88p share (0.8068 is simply the decimal expression of 71/88, so this did not represent a change in the share capital).

The shareholders simply transferred the cost records to the new holdings. The fact that the new shares allow members an option to receive dividends from a UK company or an Irish company does not appear to affect the CGT treatment.

Example

On 28 April 2008, Sunrise Acquisitions Ltd took over Scottish & Newcastle plc. The offer was 800p per S&N share, or 8 x £1 unlisted 2013 loan stock. This was a qualifying corporate bond. Anyone taking the cash option would work out a gain based on proceeds received of £8; anyone taking the loan note option would have to value the loan stock, which is difficult as it is unlisted. The information service states that the value of S&N shares on the last day of dealing should be used to calculate the deferred gain, 784.75p.

The result of taking the loan stock would therefore be a slightly smaller gain, but the cash would not be received until later. The gain on the loan stock up to redemption (i.e. the difference between the value at acquisition of 784.75p and the redemption value of 800p) is exempt from CGT.

More than one element of consideration

Where there are different elements of consideration, the base cost has to be apportioned between them. The values of the different elements are used to calculate this apportionment (that is the basis for the percentages given by the information service). The fractions of the cost are then:

- carried forward as the base cost of chargeable "paper" received in consideration;
- used to calculate a deferred gain which will be held over against exempt loan stock received;
- used to calculate a gain which is chargeable immediately in respect of cash received.

Example – shares and cash

On 17 April 2008 Thomson Reuters plc took over Reuters plc. The terms of the offer were 0.16 x a new 1000p ordinary share plus 352.5p in cash for each old 25p ordinary share.

The information service states that the first day dealing value of the new shares was 1559.5p. The cost of the original holding is therefore split 41.447% to the new shares, 58.553% to the cash received.

Example – shares and shares

In May 2008 Cadbury Schweppes plc split into Cadbury plc (traded in the UK) and Dr Peppers Snapple Group Inc. (traded in the US). Holders of 100 x 12.5p ordinary shares in CS plc received 64 x 500p ordinary shares in C plc plus 12 common stock in Dr P Inc.

C plc shares were first dealt in London on 2 May, but Dr P was not traded in New York until 7 May. The information service uses an apportionment based on values of both companies on 7 May, when both could be objectively valued. The C plc shares were then worth 643.8395p and the Dr P common stock $25.50; converting the dollar amount at $1.9528 = £1 gives an apportionment of 72.449% to the UK shares, 27.551% to the US shares.

Windfalls and loan notes

An example of a plan to enable people to "bed and breakfast in arrears" is the use of loan notes in takeovers, including demutualisations. In August 2000, a scheme was implemented by which the members of the Scottish Widows Mutual Life Assurance Society were paid for the takeover of their organisation by Lloyds TSB plc. The legal structure of the deal was:

- the members of the society acquired the rights of members by investing in certain types of investment product, such as endowment policies or pension policies;
- they therefore owned a valuable fund held by Scottish Widows, but this also entitled them to vote, and (in theory) to surpluses on Scottish Widows' liquidation – on the takeover, therefore, their rights as members were to be bought out by the bank;
- this was achieved by issuing redeemable shares in a Lloyds TSB subsidiary in exchange for the members' rights, and the number of shares received was in accordance with a formula which related to the length of time and amount of money invested in the policies held;
- members were given an option to take cash for the redemption of the shares (which followed very shortly after their issue), or instead to exchange their shares for loan notes, which could be held up to 2008, and which would be redeemable at the holder's option each 30 September or 31 March. There was a stamp duty cost in taking this option – someone entitled to £10,000 in cash would only receive £9,950 of loan notes.

HMRC's analysis of this – some of which is in the law, and some of which is in their unchallenged practice in the matter – is as follows:

- although the member paid money into the society, it is all invested in the policies – none of it was paid "for the rights", so the rights have no base cost;
- accordingly, when the shares are exchanged for the rights, the shares have no base cost;
- the cash received for the redemption of shares is therefore wholly a chargeable gain, and no taper relief was due because the shares had been held for a very short time (even if the policy had been held for much longer);
- the exchange of the shares for loan notes attached the gain to those loan notes, and it would be charged (at the full £10,000 for cashing in £9,950 of loan notes) when the loan notes were redeemed; no taper relief would accrue on the holding of the loan notes; gain was frozen, and so was the taper.

The crucial aspect of the loan notes is that they enable you to "B&B" the gain, in the sense of splitting it up and setting the annual exemptions of several years against it, in respect of an asset where this would not be possible in advance of the main disposal. The base cost of the rights could not be uplifted by triggering gains before 2000, but the whole of the gain could be deferred from 2000 and realised in tranches each year to 2008 to benefit from 8 annual exemptions.

It would be a pity to have reached 2008 still holding £50,000 of loan notes – the whole gain would then have been chargeable in 2007/08, with only one annual exemption available – but it is now too late, if that is what has happened.

Although the "windfalls" of demutualisation are a distant happy memory, the same principle may still apply on a takeover when a company offers shareholders a loan note alternative instead of cash.

Contributed by Mike Thexton

IHT and Trusts

Buy to PET

The following was published on the Taxation Forum in January 2011:

The issue

A client, in his mid-60s, invests via commercial mortgages in 'buy-to-let' properties. The lenders would probably not permit it, but we think that he could execute a deed transferring ownership to the children that need not involve the lenders.

Could he give the properties to his children as potentially exempt transfers (PETs), but to retain the borrowings on these properties,which he would service from his other income?

Summary of replies

The loss to the client's estate for inheritance tax purposes would be the full value of the properties that are transferred and the potentially exempt transfers would fall off the client's inheritance tax 'clock' after seven years with taper relief after three years had elapsed if the nil-rate band had been exceeded by the gifts.

In the event of the client's death, the outstanding balance of the mortgages would be deducted before calculating the inheritance tax liability on the assumption that IHTA 1984, s 162(4) would not preclude a deduction against the value of assets retained by the client.

It is likely that the proposed deed of gift would be in clear breach of the conditions of the mortgage.

This plan would almost certainly be a breach in the terms upon which the loans were made and if it were to be discovered by the lenders we could expect that they would call for the loans to be repaid immediately.

HMRC might be expected to mount a similar argument in the circumstances outlined.

Relief for mortgage interest

The rental income would henceforth be taxable on the children (with no deduction for mortgage interest) on the premise that they are all over age 18.

Tax relief for the loan interest payable would cease because the client would no longer have any interest in the properties or the rents from them.

Normal practice

Normally one would advise the client to declare that he holds the properties as trustee of a new trust in which there are two funds where Fund A would contain the value in the properties up to the amount of the mortgage loans and Fund B would carry the balance of the value.

Fund A would be held for the client absolutely and Fund B would be held on discretionary trusts for all members of the family including the client.

Fund A would of course retain the obligation to discharge the mortgage in full.

Provided Fund B's value is less than the IHT nil-rate band, no IHT would be payable on formation of the trust and nor would the value of the funds in Fund B represent a gift with reservation of benefit, because of the provisions of FA 1986, s 102B.

This remains the case even though all the rents continue to be taxed on the settlor (because the trust is settlor interested) and may therefore in practice continue to be paid to him. If there were any capital gain, it could not be held over.

A trust of land requires two trustees and it must be admitted that the mortgage lenders would probably still raise objections.

Administration

CIS: Was failure to pay income tax a reasonable excuse?

The appellant carried on business as a carpet and flooring contractor. B and P were the two partners of the business. B, who owned 90% of the business and was the registered partner of the appellant, applied for it to be registered for gross payment status under the Construction Industry Scheme ("CIS").

In 2009 HMRC withdrew gross payment status from the appellant pursuant to FA 2004 s 66 on the basis of B's failure to pay income tax by the due date (31 January 2009) in breach of the "compliance test" as required for the purposes of the CIS. Although B paid £15,000 of her income tax liability for 2007/08 before the due date, £5,000 was paid 14 days late and £1,629.33 was paid 42 days late. In addition, her first payment on account for the 2008/09 tax year (also due on 31 January 2009) was also paid late: £8,370.67 was paid 42 days late and £1,673.61 was paid 76 days late.

Under FA 2004 s 64(3) where an individual applied for gross payment registration as a partner in a firm "(a) the applicant must satisfy the conditions in Part 1 of Schedule 11 to this Act (if an individual) or Part 3 of that Schedule (if a company) and (b) in either case, the firm itself must satisfy the conditions in Part 2 of that Schedule." Under FA 2004 Sch 11 paras 4(1)(a) and 8(1)(a) the applicant had to have complied with "all obligations imposed on him in the qualifying period … by or under the Tax Act or the Taxes Management Act 1970". Paragraph 32 of the Income Tax (Construction Industry Scheme) Regulations 2005, SI 2005/2045 provided that a failure to pay income tax by the due date was to be ignored for the purposes of the compliance test, providing payment was made within 28 days.

The appellant appealed on the basis it had a "reasonable excuse" within the meaning of FA 2004 Sch 11, paras 4(4)(a) and 8(3)(a) and TMA 1970 s 118(2). It argued that the late payments of income were made in circumstances that were wholly exceptional for the following reasons: (i) the tax payments in question fell due at the end of January 2009 and the appellant's business was in a dire financial position caused directly by an unprecedented financial crisis.

By January and February 2009 the business was almost wiped out: turnover had fallen by 68.65% for January and by 85.22% for February; (ii) the partnership funds were inadequate to meet the tax liability as well as the wage bill for January; (iii) the outstanding tax was paid as soon as possible and it had a good record for compliance in the immediately preceding 12 months for all taxes; (iv) if it lost its gross payment status many of its customers would not put it on their subcontractors' list which would result in the closure of the business and the redundancy of its employees (three specialist fitters and one office worker); and (v) it had paid interest and penalties in respect of the late payment of tax and it was disproportionate, therefore, of HMRC to take further action which threatened closure of the business.

HMRC argued that (i) late payment of income tax could only be ignored under para 32 of the Regulations where the payment was no more than 28 days late; it was paid more than 28 days late in the present case and could not be ignored; (ii) there was no documentary evidence to support a claim that there were severe cash flow difficulties for the business and it was for B to demonstrate that she personally had a reasonable excuse for delay in respect of the payment of tax; (iii) the business accounts showed that the business cash flow problems were largely due to the levels of drawings by the partners from the business; and (iv) the consequences of the loss of gross payment status could not be taken into account in determining the question of whether there was a "reasonable excuse".

The tribunal considered that the consequences of withdrawal of gross payment status could not be taken into account when determining whether there was a "reasonable excuse", within the meaning of FA 2004 Sch 11, paras 4(3) and 8(3) and TMA 1970 s 118(2), for non-compliance. The statutory provisions examined whether there was a reasonable excuse for the failure in question and did not permit the tribunal to investigate the consequences of withdrawal of gross payment status.

On the facts the appellant did have a reasonable excuse. The appellant, including B, experienced cash flow difficulties beyond its control from the end of January 2009 to the date when the balance of the self-assessment payment was made. That period coincided almost exactly with one of the worst financial crisis in the UK's history. It was apparent from B's tax return that her sources of income

© Reed Elsevier (UK) Limited

other than that derived from the partnership were very limited. Therefore the exceptional circumstances that caused the near failure of the appellant's business constituted a reasonable excuse. It followed that the appeal would be allowed.

Appeal allowed.

Connaught Contracts v Revenue and Customs Comrs TC 798

27 October 2010

Summary of new penalties to tackle offshore tax evasion

HMRC has announced new penalties for offshore non-compliance.

These new penalties come into force from 6 April 2011 and apply to Income Tax and Capital Gains Tax. The first Self Assessment returns affected will be for the 2011-12 tax year, with paper returns due to be filed by 31 October 2012, and electronic returns by 31 January 2013.

The legislation can be found in Schedule 10 of Finance Act 2010.

How it works

The new penalty is an enhancement of the penalties for

- failure to notify
- inaccuracy on a return
- failure to file a return on time

Under the new legislation, these penalties will be linked to the tax transparency of the territory in which the income or gain arises. Where it is harder for HMRC to get information from another country, the penalties for failing to declare income or gains arising in that country will be higher.

There will be three new levels of penalty:

- where the income or gain arises in a territory in 'category 1', the penalty rate will be the same as under existing legislation
- where the income or gain arises in a territory in 'category 2', the penalty rate will be 1.5 times that in existing legislation - up to 150 per cent of tax
- where the income or gain arises in a territory in 'category 3', the penalty rate will be double that in existing legislation - up to 200 per cent of tax

The Treasury has laid legislation before Parliament which describes which territories are in 'category 1' and 'category 3' (www.hmrc.gov.uk/news/territories-category.htm). All other territories (except the UK) are in 'category 2'.

All existing safeguards will still apply. There will be no penalty if a person can demonstrate they have taken reasonable care to get their tax right or have a reasonable excuse for a failure to notify taxable income.

Where penalties are due, HMRC can reduce them depending on how helpful the individual is in assisting it to establish the correct amount of tax due. The largest reductions will be for unprompted disclosures. Unprompted means when you tell HMRC about a tax issue you have no reason to believe they have discovered or are about to discover it.

Clinets are advised to contact HMRC now to get their tax affairs in order before these new penalties come into force.

NPS – where are we now? (*Lecture B636 – 12.47 minutes*)

Background

The NPS system went live in July 2009. It is a computer system organised by employee, so that all employments are brought together in a single records, enabling the employers to calculate and deduct tax more accurately, as the system will allocate personal allowances etc between employments as necessary.

The system was populated with data brought together from the old employer based computer systems which were held regionally. On the old systems, employees only existed in relation to each employment so it was not possible to amalgamate tax records year by year for those with multiple employments. Consequently, the employee records needed to be reconciled annually – a task which has not been performed for several years.

One of the key migration issues was the poor state of the employee records on the legacy systems – some 12 systems. There was a considerable amount of redundant data which was not adequately identified before the migration and this led to significant issues in Spring 2010 when the coding run commenced.

Annual coding run

The 2010 coding run which started in late January produced a very considerable number of issues, with many individuals receiving multiple codes and many of these relating to old employments which had ceased years before. This was caused by a failure to cleanse the employee records adequately before the run was carried out – but HMRC had decided that this was the easiest way to identify all of the issues. It is fair to say that the authority was probably dismayed by the volume of incorrect data they were dealing with.

Information on the 2011 coding run was issued on 14 January 2011. It is anticipated that the coding run will be less troublesome than last year, as much of the data has now been cleansed – some of it manually. HMRC's announcement states that the IT fixes and manual checking employed over the last year has provided confidence in the records – which have been extensively tested in the run up to the coding run commencing.

The number of coding notices sent to employers this year is a staggering 17 – 18 million. These will be issued between 23 February and 25 March. The individual versions of these started to be issued on 17 January, and this will run through to 16 March. However, it is important to remember that **agent copies will no longer be issued**, so you will need to ensure that your clients pass these to you – or contact you if they are in any doubt. It is still possible that employee will receive more than one notice of coding – as one will be issued for each source of employment or pension. In particular as some pension providers may deal with a number of occupational schemes, there may be multiple coding notices for a single pension provider, but these will relate to each scheme or payroll on which the individual is included.

Benefits and expenses

P11D returns are processed to another computer system known as the Employer Compliance System. This system normally interacts with NPS and passes over the data on benefits etc so that they are reflected in notices of coding. This link was switched off during 2010 so that the NPS notices of coding issues could be resolved, and the data interface tested before going live. In consequence the 2009/10 P11D's were only processed to NPS from November 2010. Normally this interface would operate during July as P11D's are filed. During November and early December around 4.7 million P11D's were processed to employee records.

Where the result of this data flow was a liability for 2009-10 of up to £2,000, this will reflect on the notice of coding for 2011/12 being issued now. Taxpayers with a liability of more than £2,000 for 2009/10 were contacted to arrange payment. Note that the moratorium on collecting underpayments of less than £300 applied only to the reconciliations in respect of 2008/09 and earlier years, and not to 2009/10.

The data was also used to update codes to reflect current benefits (according to 2009/10 P11D's), and again this would normally happen during the summer of each year. P2's and P6's (notices of coding for employee and employer respectively) would be issued at this stage.

Reconciliations

The annual reconciliation of taxpayer records has not been carried out for several years, and the implementation of NPS has allowed much of this to be automated now. This, again gave rise to significant adverse publicity for HMRC in the autumn of 2010 when P800 tax calculations started to be issued. The current position is as follows :

2009/10

As noted above, the processing of P11D data allowed the 2009/10 reconciliations to proceed automatically. By the end of 2010 90% of 2009/10 records were fully reconciled and taxpayers had been notified and repaid any overpayments. The balance of 2009/10 cases will be cleared by the end of March 2011. It is anticipated that the annual reconciliations should provoke limited problems in future. The process outlined above for 2009/10 will be applied for future years, although this will start much earlier in the year.

2008/09

The reconciliation work commenced in autumn of 2010 started with 2008/09, the most recent complete year (P11D's from 2009/10 not being available at that time). The resulting tax calculations attracted much publicity, and the following approaches were applied :

- All overpayments were dealt with and repaid to taxpayers – with in excess of £1 billion having been repaid by the end of 2010.
- Underpayments of less than £300 were subject to a de minimis and not pursued. This enabled HMRC to concentrate resource on larger debts.
- Some taxpayers were able to claim the benefit of ESC A19, under which if HMRC had all of the information relating to the taxpayer's position and failed to act promptly on it, the tax due would be remitted.
- Some of the larger liabilities have been tackled with sensitivity and taxpayers offered up to three years to pay with no interest charges. Each case is dealt with on its merits.

State pensioners

Where an underpayment relating to either 2008/09 or 2009/10 relates to the payment of state pension which has not been reflected through PAYE codes in employment or occupational pension. Underpayments relating to these errors in relation to state pension payments that **commenced in 2008/09** or earlier have been dealt with under ESC A19 on a blanket basis, so that tax underpayments resulting from a failure to code out state pension entitlement for both of these years have been cancelled.

Where the coding error relates to a state pension which commenced in 2009/10 then the debt will be sought from the taxpayer as the conditions for ESC A19 have not been met.

Earlier years

No underpayments will be pursued in relation to 2006/07 or earlier years; HMRC will review cases where it is anticipated that a repayment will be due.

For 2007/08 underpayments of under £300 will not be collected, but the remaining 400,000 taxpayers who owe tax for that year will be contacted. The tax will, as far as possible, be coded out in 2011/12.

Ministerial statement

David Gauke MP, Exchequer Secretary to the Treasury (Minister with responsibility for HMRC) made a written statement to the House of Commons on 11 January 2011 as follows :

"HMRC have been working hard to clear the long-standing backlogs of unreconciled tax cases.

Since September they have made rapid progress on working through the nearly 6 million adjustments needed to ensure that the correct amount of tax is collected for the tax years 2008-09 and 2009-10. By the end of last year in 90 % of cases where HMRC had received all relevant information, customers had received a refund notice or a calculation of overpayment in respect of these years.

In cases where an underpayment was due HMRC have sought to take a flexible and sympathetic approach to collecting the tax that is due. In the minority of cases where the unexpected bill has been caused by HMRC's failure to act promptly on the information received, HMRC have considered claims to be written off under an existing concession (ESC A19).

In addition:

> HMRC estimate that there are about 250,000 cases in respect of 2008-09 and 2009-10 where a taxable state pension has been paid by DWP and the tax due on this pension should have been collected through a tax code adjustment. These pensioners have not yet been issued with a notice of underpayment but would have a strong case for their underpayment to be written off in line with the concession. HMRC will not require these pensioners to claim the concession individually, but will instead write off all the relevant underpayments.
>
> HMRC are working to clear the backlog of cases from earlier years. They will work all cases where a taxpayer is due a repayment for earlier years.
>
> Further underpayment notices will not be issued for years earlier than 2007-08. For 2007-08, where possible, any amounts due will be included in the tax code for 2011-12 so that the money is collected over the course of the year through PAYE. HMRC will apply the same treatment to these cases as to those for 2008-09 and 2009-10. HMRC will not be collecting sums for less than £300 for that year and will allow people to spread payments in cases of hardship. Taking these concessions into account, HMRC expect to be in touch with around 450,000 people before the end of March to collect underpayments to the value of some £180 million.
>
> The annual exercise to set tax codes for the 2011-12 tax year is about to begin. HMRC have reviewed the experience of last year when transitional issues with the new system led to some taxpayers receiving incorrect tax code notifications, and have conducted extensive additional testing designed to prevent a recurrence of these issues this year."

Other issues

50% tax rate

It has not been possible to reflect in coding notices the need for an individual to suffer 50% tax in one employment. This issue will crop up for those who have multiple employments which put them over the £150,000 limit. Those with a single employment will not be affected.

HMRC is working to identify those affected and they will be included within Self Assessment from April 2011 to allow this liability to be collected. In future it is hoped that this issue can be dealt with through coding adjustments, but at present this is not possible.

Real Time Information

The intention to proceed with plans to collect Real Time Information from employers as payments are made to employees was confirmed in late 2010. For many employers this data will have to be provided as part of the BACS data, but for smaller employers the data can be supplied through the Government Gateway. This represents a significant challenge for payroll software developers and employers alike, but must commence on time to allow the new "Universal Credit" benefit system to be implemented, as that system will rely on RTI data. The implementation of RTI should also eliminate much of the reconciliation work for employees.

Contributed by Rebecca Benneyworth

New CIS penalties (*Lecture B638 – 14.53 minutes*)

Monthly CIS300 returns

Monthly submission of these returns within 14 days of the end of the tax month means that there is no more waiting until the end of the tax year. Problems of non-submission and non-deduction of the standard-rate (20%) or higher-rate (30%) CIS tax should be identified much earlier, enabling HMRC to take the appropriate action.

Late returns

Currently, late returns penalties are as follows:

- £100 in first month if < 50 subcontractors involved (£100 for each extra batch or part batch
- £200 in second month for the first late CIS return (+ further £100 for the second late return)
- penalties continue to increase for every month that each return is late.
- Extra penalty up to £3,000 for returns which are 12 months late (subject to mitigation)

New penalty regime from November 2011 return

HMRC have decided that the new penalties can be applied retrospectively if requested:

- Immediate fixed penalty of £100 if a return is late.
- Second fixed penalty of £200 two months after filing date if the return is still outstanding.
- If the return is still outstanding six months after the issue of the first penalty, a tax-geared penalty will be charged, which is the greater of 5% of the amount of deductions shown on the return, or £300.

Penalty capping provision

Where new contractors are filing their first returns late, there will be an upper limit of £3,000 on the total fixed penalties (£100 and £200) that may accrue.

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

Failure to register

HMRC recognise that a great proportion of those who have never previously registered to operate the CIS scheme were not contractors in the usual sense and were not 'mainstream' construction industry businesses.

Many contractors have fallen foul of the CIS penalty regime being businesses, particularly smaller businesses, that did nothing to correct matters and even ignored penalty notices when the problem came to light.

Such 'new contractors', being oblivious to the requirements to submit monthly CIS300 returns, will, in addition to racking up penalties, have failed to verify the tax payment status of the subcontractors paid by the business.

Advisers therefore need to be on the lookout for contractors who are not in the 'mainstream' construction industry who are unaware of their CIS obligations.

iXBRL – what you need to do now! (*Lecture B639 – 14.25 minutes*)

Companies and other entities submitting corporation tax returns have very little time left before mandatory electronic filing commences.

From 1 April 2011 all corporation tax returns must be filed online using iXBRL for accounting periods ending after 31 March 2010.

Those firms wishing to "buy more time" to adopt iXBRL – will need to file accounts early – that is before 1 April 2011 – in order to buy a little more time to adopt compliant procedures and software. For example, a company with an accounting period year ended 30 September 2010 can still file in the old fashioned way (on paper or electronically with accounts attached as a PDF).

What next?

The requirement to file using iXBRL comprises three elements :

- The corporation tax return itself must be filed in XML format
- The computations supporting the return (the adjustment of profits, capital allowance computations and similar) must be filed in iXBRL format, and
- The accounts or financial statements on which the return is based must also be filed in iXBRL format.

iXBRL format provides the data to HMRC (or Companies House) together with "tags" identifying the nature of the data. HMRC are working to a standard list of tags based on UK Generally Accepted Accounting Practice (GAAP), some of which are mandatory items, and some of which are optional tags.

Producing accounts in either Excel or Word – as many accountants and indeed companies do – does not easily lend itself to iXBRL and tagging. The documents need to be manually tagged so that each data item has an appropriate tag attached to it. When the data (and tags) are submitted to HMRC they can then be processed and viewed in the same format as that used by the preparer of the document – but the provision of the underlying data allows HMRC to perform much more sophisticated checks on the figures provided, by using computerised analytical tools. Compliance in corporation tax will change for ever once iXBRL becomes mandatory!

How to tag, what to tag?

Manual tagging solutions currently available in the market place allow users to add tags to documents which have been prepared in Word and Excel, so that these can be used alongside iXBRL compliant tax software. However, this is a very labour intensive job; some outsourcing arrangements are even sending accounts to India for manual tagging – this clearly conveys how labour intensive this is.

Added to this the user will need to learn how to attach the tags to data, and in many cases what is the minimum tagging that is acceptable. Not every single item of information in the accounts and computations must be tagged, so those that are required comprise the "minimum tagging list". The issue of minimum tagging is a difficult one. At present HMRC is working off quite a short minimum tagging list, but this will be expanded once iXBRL has bedded in; this will inevitably lead to a longer learning period, while users adjust to increasing required tagging levels over the next few years. So the "learning curve" will go on and on for those who adopt manual tagging solutions.

Some firms may decide to go down this route until they can decide which software they will use in the future. This option is almost the worst of all possible worlds, as it involves learning how to use the tagging solution, only for that knowledge to become redundant when new software is selected for a more permanent solution.

Intelligent tagging tools

There are "smart" or "intelligent" tagging solutions and tools emerging now which will speed up the tagging operation a little by suggesting the tags and making recommendations as to how items should be tagged. Similar to voice recognition software, these tools will "learn" what tags are applied to items of data and make recommendations based on this.

While one might expect that this will improve productivity, it still falls into the manual tagging category and will therefore present a challenge for firms looking to make profits from small company work. A significant fee increase to recoup additional costs is unlikely to be acceptable to your client.

Alternative approaches

One "half way house" to a full integrated solution is to use HMRC's free software offering to complete and file corporation tax returns and accounts and computations. The data is entered into a "smart" PDF which already includes the tags, so the data is entered against the tags rather than vice versa.

However, many currently using this alternative find it slow and rather clumsy; and of course it is almost less productive still than manual tagging, as it requires the re-inputting of the required data into the HMRC software; firms are unlikely to adopt the output as formal accounts to present to a client, so in effect the accounts are prepared twice – once in Word or Excel, and then re-typed into the HMRC filing facility. Add to this that the software has limitations much like the free software for income tax filing with certain types of income etc excluded, then this hardly looks like a comprehensive solution.

Using iXBRL ready accounts software

The only way to replicate current workloads and therefore profitability under the current regime, once mandation of iXBRL commences is to use accounts preparation software which includes iXBRL functionality.

When client accounts are prepared using software with pre allocated tags, once the figures are finalised they are also ready tagged so that iXBRL filing is essentially as simple as printing the accounts. The software will enable preparation of final accounts to comply with relevant legislation (such as Companies Act requirements) but there is no requirement to add tags or decide which information must be tagged – this part is all embedded in the software. As the software is geared towards final accounts production, the printed output is suitable to use for submitting to the client, and almost as a by-product, the iXBRL tagged file will also be generated.

Ideally, the software will permit the user to add manual tags too – to provide maximum flexibility when client companies have unusual disclosure items.

For the smaller practice, the case for separate free standing iXBRL accounts software is almost overwhelming. While those who wish to may invest in fully integrated accounts/corporation tax packages, this may leave the preparation of partnership (including LLP) and sole trader accounts to be done using other software targeted at entities filing income tax returns, for which no iXBRL is necessary. Free standing accounts software will frequently be compatible with your existing corporation tax software – and you may be reluctant to change both accounts and CT filing processes this spring. Purchasing accounts production software which can be used with any CT filing package gives the best of all worlds, and minimises the cost of keeping the practice compliant.

Where a solution is sought for iXBRL filing only, the practice should ensure that their chosen solution meets an appropriate price structure when it is to be used for a small number of clients. Using packages which are "pay per use" or provide useage price points can be the most cost effective solution for a practice with only a small number of limited company clients.

The "bolt together" solution

Where accounts preparation software can be integrated through a communication module to both CT filing and IT filing modules, the practice has a powerful solution. Staff use a single accounts production package for all clients, which provides output to printed accounts, iXBRL files, and basic data for the tax returns – be they Income Tax self assessment or partnership returns, or Corporation Tax returns and computations in iXBRL format.

The data is provided to the tax module directly, so that there is no re-keying, reducing the risk of errors. Adding further computational items to provide a full capital allowances and computation, the user has no additional work over and above the current workload, but maximum flexibility. Using the same module for all accounts production will ensure that staff can be moved between small company accounts work and sole trader partnership work with no additional software learning required.

Summary

For the smaller practice the transition to iXBRL filing is now urgent. Those making the choice of software solutions may consider that there is no other option open to them than to use an interim solution of manual tagging with their own current systems while they assess the next step.

While this may appear to be a cost effective solution, the hidden costs in terms of staff time learning how to tag and what to tag – and in potentially numerous rejected CT filing attempts – makes a more permanent solution in the form of iXBRL ready accounts software an attractive proposition.

There is a very wide range of packages available from substantial multi user options to small systems for the practice with only a few limited company clients.

Contributed by Rebecca Benneyworth

Business Tax

A partnership plan (*Lecture P636 – 14.16 minutes*)

The following was published on the Taxation Forum in January 2011:

A mother, father and their two sons trade as a partnership and are considering whether they could mitigate their tax liability by including a limited company as a partner

The family run a trading partnership with annual profits of approximately £400,000 where, when combined with other income, the individuals are exposed to the new higher rate taxes.

Incorporation is the obvious tax-saving solution, but because of issues surrounding benefit-in-kind rules, the clients do not wish to transfer outright to a limited company.

The client has suggested setting up a limited company which would become a partner alongside the other family members. The shareholders in NewCo would be the existing partners. This would result in the company's share of profits being assessed at the lower 21% rate, rather than the 51% applicable to the individuals.

Summary of replies

Settlements legislation

In this scenario, the partners are transferring an interest in their partnership to a company, where income is taxed at a lower rate, but retain an interest in that income by virtue of their shareholdings.

If individual family members subscribe for shares and pay in full, there should not be a problem. To avoid the settlements legislation, the shares need to be ordinary shares carrying full rights. Do be aware that unusually high capital returns, differing dividend entitlements and waivers are all areas where HMRC are likely to become interested in trying to apply the settlements rules..

The legislation found in ITTOIA 2005, Part 5 Ch 5 is designed to catch circumstances where taxpayers try to avoid punitive rates of tax by transferring income-producing assets so that income is received by others at a lower rate of taxation, but the original taxpayer still derives a benefit from the income in some way.

Case law has determined that for an arrangement to be within these anti-avoidance rules, there must be an element of 'bounty'. So provided that company brings something commercial to the partnership, the rules do not currently apply. In practice, the company might contribute finance, intellectual property, or some other asset such as land or machinery to the partnership.

Capital gains tax

Under Statement of Practice D12, the admission of a new corporate partner into a partnership is regarded as a part disposal at market value by existing partners. Partners should be able to reduce their base costs by the gain made using holdover relief.

When shares are sold, entrepreneurs'relief may be available; this will turn on the extent to which the company participates in trading activities as opposed to having a merely passive role.

Inheritance tax

Shares in the company may or may not qualify as business property depending upon the company's activities. It will be advisable to ensure that the usual conditions in IHTA 1984, s 105 continue to be met at the time of the transfer of value – particularly the requirement that the business is not wholly or mainly making or holding investments and that the shares have been held for two years. It is worth documenting the reasons for holding cash in the company.

Employment issues

If the partners are appointed as directors or employees and receive shares as a result of any bargains not at arm's length, then the employment related securities rules may apply.

The application of IR35 may also be relevant, depending upon what the company does with its profits and how cross charges for directors' services are made.

No trade losses arose from the described activities

The appellant, who together with an African company, had invested in a bi-fuels and paper pulp business, appealed against HMRC's denial for claimed loss relief, as well as their request for a stay in appeal proceedings while an investigation was underway.

The problem arose after HMRC rejected the taxpayer's 2006/07 self assessment return in which he claimed a repayment under the sideways loss relief rules in TA 1988, s 380 and s 381 against his employment income.

Later that year, HMRC opened an enquiry and withheld the claimant's repayment of tax. In October 2008, the department requested information relating to the technicalities of bio-fuel and pulp trading, together with copies of any feasibility study undertaken that concerned the activities of the African investors. The appellant could provide neither.

On 29 September 2009, HMRC filed a closure notice concluding that no trade losses arose from the described activities, and therefore made the amendments to the appellant's tax return, cancelling the loss relief claim as well as refusing the repayment.

The appellant appealed.

At the same time, HMRC opened a criminal investigation into the marketing surrounding the scheme, on the basis that fraudulent returns had been submitted.

The appellant, however, was not under investigation; when HMRC applied for the appeal to be stayed on the grounds that it would prejudice to the criminal investigation, and also an extension of time to serve their statement of case, the appellant objected.

Points to address

The tribunal had two points to address.

1. Was it 'just and convenient' to direct a stay for the purpose of dealing with the appeal 'fairly and justly'.
2. Would it be 'proper and right' to direct a stay in order to assist a criminal investigation that did not concern the appellant directly.

Conclusions

The tribunal concluded that due in part to the appellant's inability to provide HMRC with as much relevant factual information as possible, a six-month delay, which would in turn enable the Revenue to gain further evidence, would be beneficial.

HMRC's applications were allowed.

Swallow (TC742)

Cleaners: employed or self employed

The appellant operated a cleaning management company, providing commercial services. Cleaners had to pay a service bond for the contracts, and the appellant took a percentage of the fees. The firm treated the cleaners as self-employed, but HMRC claimed they were employees.

The company appealed.

The First-tier Tribunal looked first at mutuality of obligation, referring to various cases, including Dragonfly Consulting (SpC 655). The tribunal noted that the pay records gave 'the strong impression of employment' because the same workers were taken on weekly to clean for regular customers and paid a set amount for the work.

With regard to control, it was clear from the evidence that the workers had virtually no control over their jobs; the company told them when and where to carry out their work. In addition, the firm regularly checked the quality of the work.

Looking at substitution, the tribunal noted that the company paid neither sick pay nor holiday pay, but said this was not a conclusive indicator that the workers were self-employed.

The tribunal also looked at whether the workers incurred financial risk, but found that although the company asserted its self-employed cleaners were expected to provided their own cleaning materials, there was no evidence they did.

As to the intention of the parties, the appellant argued that the workers were self-employed, but the cleaners believed they were employees.

The tribunal concluded that the workers were engaged under a contract of service and were employees.

The taxpayer company's appeal was dismissed.

Red Apple Cleaning Management Ltd (TC860)

Corporation Tax

Dividends checklist: Get the details right

Writing in AccountingWeb, Jennifer Adams sets out a checklist for ensuring that dividend payments will meet with HMRC's approval.

My previous article on directors' loan accounts explained that the debit balance on a directors loan account is repaid either in cash or more usually via dividend. The dividend procedure is just a matter of making the correct journal entries to show the final amount declared in the correct place on the balance sheet – yes?

Not quite. HMRC are increasingly contending that such dividends are in reality earnings under the s62 ITEPA 2003 (salary sacrifice) rules and to persuade them otherwise needs proof that a set procedure for the declaration of dividends has been followed.

The following check sets out points to consider when preparing such a procedure:

1. The dividend must be legal

Companies Act 2006 (CA 2006 (s830) states that *'a company may only make a distribution out of profits available for the purpose'* – it is vital that director/shareholders appreciate what this means. Namely that even if the bank account is in credit the company needs to have sufficient retained profits to cover the dividend at the date of payment.

'Profits' in this instance are '*accumulated realised profits less ....accumulated, realised losses'*(CA 2006 (s830 (2))

Any dividend paid in excess of this profit, or out of capital or when losses are made is 'ultra vires' and, in effect, 'illegal'.

The financial status of the company therefore needs to be considered each time a payment is made. If regular amounts have been withdrawn (including the monthly payments our clients all insist on drawing in lieu of salary) then the amounts are deemed 'illegal' if at the date of each payment the management accounts show a trading loss or the profit cannot support the payment. HMRC will argue that *'in the majority of such cases'* the director/shareholder of a close company will be aware (or had reasonable grounds to believe) that such a payment as dividend was 'illegal' (CTM20095 (27 and 29) and *It's A Wrap (UK) Ltd. v Gula & Anor [2005] EWHC 2015).*

Full accounts are not required for the calculation of an interim dividend. Accounts of the detail that enables *'a reasonable judgement to be made as to the amount of the distributable profits'* at the date of payment are acceptable (CTM20095 (17)) (also see *'Proper Declaration of Dividend'* below).

A significant consequence of payment of an 'illegal' dividend could arise if the company goes into liquidation and the liquidator or administrator routinely reviews the conduct of the directors over the three years prior to insolvency. If it is found that a dividend has been paid 'illegally' then CA 2006 s847 provisions apply and the directors will be expected to repay the amount withdrawn. (See *Bairstow v Queens Moat Houses plc [2001] 2 BCLC 531* and *'Do directors actually have the right to receive any remuneration - 30/01/2010*). HMRC will actively pursue this route being as they are often the largest unsecured creditor. All members should read '*First Global Media Group Limited v Larkin [2003] EWCA Civ 1765)'* to appreciate how far HMRC will go in this matter and the importance of correctly dated and produced documentation.

2. Proper declaration of dividend

Directors can authorise payment of interim dividends (see new *Table A s30 (1)*) but final dividends need to be approved by ordinary resolution confirmed by a simple majority of shareholders; following CA 2006 this can now all be done in writing – no meetings are required.

Therefore suggest a standard text is prepared confirming due consideration of accounts and authorisation of the dividend (whether interim or final) which is signed and dated by the director at the time each payment is made. Indicator publishes 'Essential Documents for Saving Tax' which contains an example of draft minutes and written resolution that could be adapted for use.

Dividend payment date

Dividends are treated as paid on the date that the enforceable debt is created; where there is no such debt, the date of payment is used. Therefore the relevant date for an interim dividend is the actual date of payment because a resolution is not needed to confirm payment; such a dividend can be varied or rescinded.

Note that HMRC consider the date of payment of interim dividends to be the date of entry in the company's books. (see CTM 20095 (8))

A final dividend becomes an enforceable debt when approved by resolution therefore the relevant date is the date of declaration unless a later date is specified. (see *Potel v CIR (1970) 46 TC 658* and SAIM5040).

Many believe that backdating documents to confirm consideration of profit and payment of dividend is a paperwork tidying up exercise but technically it is fraud (see '*Back dated dividends (again) – 12.06.2008* and '*First Global Media Group Limited v Larkin [2003]' EWCA Civ 1765)*

4. Dividend vouchers

A single dividend tax voucher covering the whole tax year is permissible.

Dividend vouchers do not have to be presented at the time of payment.

The Income and Corporation Taxes (Electronic Certificates of Deduction of Tax and Tax Credit) Regulations 2003 (SI 3143/2003) authorises the electronic delivery of dividends. See the ICSA guide Communications with Shareholders 2007.

The ideal world – summary checklist

See Simon Sweetman's 2007 advice in *Tax expert warns of the danger of illegal dividends* – a board meeting is no longer needed but written confirmation is vital.

Jennifer Adams

AccountingWeb 4 January 2011

Close investment –holding company (CIHC) (*Lecture B637 – 18.58 minutes)*

The appeal concerns whether the Appellant was a close investment-holding company; if so, the Appellant would be disqualified from benefiting from marginal rate relief available to "small" companies.

Small companies relief

Section S34 CAT 2010 (13A ICTA) contains the full definition of a CIHC.

For the company in question, the dispute was whether the Appellant satisfied the requirements of section 34 (2)(b) throughout the accounting period ended 31 May 2008:.

This section provides that a company is not a close investment holding company, and so entitled to marginal relief, provided that it is making investments in land and letting the land to unconnected persons.

The facts

It was common ground that the Appellant was a close company for the accounting period ended the 31 March 2008.

In 1962 the Appellant acquired a property at 29 Holywell Hill, St Albans ("the Property") for the purposes of its photography trade. At that time, Mr Giffen's father and grandfather ran the business.

The Appellant ceased to carry on its photography trade in 1996. From 1996, for a period of seven years, the Appellant leased the Property to a friend of Mr Giffen. Then, in 2003, the Appellant leased the Property to a new tenant on a 10 year lease.

In 2006 there was a dispute about a major sewer leak. Following a meeting, Mr Giffen decided that the Appellant should sell the Property to the new tenant. Mr Giffen said that he was

influenced by his agent who suggested that the Appellant could sell the Property and buy another one. Eventually, after various difficulties, the sale was completed on 12 June 2007.

According to Mr Giffen, he took a few months off after the sale of the Property as he was recuperating from heart surgery. He argued that it was still his *intention* (and therefore the Appellant's intention) to reinvest the sale proceeds in other properties when the property market recovered. Consequently, in Mr Giffen's view, throughout the accounting period ended 31 May 2008 the Appellant existed wholly or mainly for the purpose of making investments in land where the land is, or is intended to be, let to third parties.

HMRC

HMRC were of the opinion that the company was a CIHC for the year as the company had not:

- let the property throughout the period; or
- made any attempt to buy a replacement investment property to let out during that period

Decision

If the Appellant could establish that it had the necessary investment intention in the accounting period ended 31 May 2008, but that purpose ceased to exist in a subsequent accounting period, the Appellant would be entitled to marginal rate relief, assuming all other requirements of the statute were satisfied.

After careful consideration, the Tribunal accepted:

- Mr Giffen's evidence that he intended the reinvest the proceeds of sale of the Property in acquiring residential properties as a rental investment throughout the accounting period ended 31 May 2008.
- the impact of the financial crisis led Mr Giffen to hesitate from procuring further rental properties but that it was still his intention to do so.

The Tribunal considered it is unnecessary for them to determine the Appellant's purposes in later periods and the absence of documentary evidence as to the Appellant's purpose did not require them to disregard Mr Giffen's evidence.

For these reasons they allowed the appeal.

TC00868: Herts Photographic Bureau Ltd

Release date: 7 December 2010

© Reed Elsevier (UK) Limited

Value Added Tax

Simplification of the change in use provisions

This Brief announces a simplification of the 'change in use' provisions (Paragraphs 35 to 37 of Part 2 of Schedule 10, VATA 1994 by Value Added Tax (Buildings and Land) Order 2011.

With effect from 1 March 2011, there will no longer be two adjustment mechanisms (each with its own rules on how to calculate and apply a tax charge) to apply to the two sets of circumstances where a 'change in use' occurs.

Instead, there will be a single adjustment mechanism to be applied in all circumstances. It will be based on the:

- amount of VAT that would have been chargeable on the original supply (or supplies) had the building in question not been eligible for the zero rate;
- proportion of the building that is affected by the change in use, and
- number of complete months that the building has been used solely for a qualifying purpose prior to the change in use.

These changes have been made following a consultation, announced in Revenue & Customs Brief 49/10, on proposals to simplify the provisions.

Further information on whether a 'change in use' has occurred and how to calculate the tax charge can be found in VAT Information Sheet 04/11, which will be published shortly.

Revenue & Customs Brief 05/2011

Changes to the option to tax

The introduction of a new '2 per cent occupation rule' and a change to the way that occupation by reference to Automatic Teller Machines is treated.

1. Introduction

This Brief explains minor changes which are being made to the option to tax anti-avoidance rule. Currently the option to tax is disapplied where the grantor, or a person connected to the grantor, is in exempt occupation of the land (and the other conditions in the anti-avoidance rule are met). The changes to be introduced from 1 March 2011 mean that an option to tax will no longer be disapplied where the grantor or persons connected with the grantor only occupy minor parts of buildings (no more than two per cent) even if the other conditions of the anti-avoidance rule are met.

The treatment of Automatic Teller Machines (ATMs) is also being amended. From 1 March 2011 occupation of any building which is solely by way of ATMs will not be treated as occupation for the purposes of the anti-avoidance test.

2. Who needs to read this?

Anyone who makes supplies of land and buildings which are subject to the anti-avoidance rule in VATA 1994 Schedule 10 paragraphs 12 to 17. See Notice 742A Opting to tax land and buildings section 13 for details about how the rule works and transactions that are likely to be affected.

© Reed Elsevier (UK) Limited

3. Background

Under the anti-avoidance provision in Schedule 10 of the VAT Act, an option to tax is disapplied where two key tests are satisfied:

- the grantor is a developer of the land
- the grantor or development financier intends or expects that the land will become 'exempt land'.

As a result of the disapplication of an option, the grantor's supplies are exempt from VAT. This can affect the amount of VAT the grantor is able to reclaim on costs.

The amendment concerns the second of the above tests – the meaning of 'exempt land'. Under paragraph 15 of Schedule 10 VATA 1994 land is 'exempt land' if it is to be occupied by the grantor, the 'development financier' (a person who has provided finance for the purchase or development of the land) or a person connected to either the grantor or financier, and the occupation is not 'wholly or substantially wholly for eligible purposes'. To be in occupation for eligible purposes a person must be making predominantly taxable supplies (or supplies which entitle the person to input tax recovery). 'Wholly or substantially wholly' is defined as at least 80 per cent.

The mechanistic nature of the anti-avoidance test has resulted in concerns about the effect of the measure on certain transactions. Following representations to HMRC the test was amended from 1 April 2010 and a new 'ten per cent occupation test' was introduced. This allowed occupation of no more than ten per cent of a building by a person providing finance for its purchase or development to be ignored. HMRC have subsequently been made aware of instances where minor occupation by the grantor (or a person connected to the grantor) can cause an option to be disapplied even though there is no deliberate attempt to avoid tax. The change, which is effective from 1 March 2011, addresses that concern by introducing a further 'two per cent occupation rule' applicable where the grantor himself or a person(s) connected to the grantor is to be in occupation. The new rule supplements the existing ten per cent rule.

4. Details of how the new '2 per cent occupation rule' works

Occupation of any part of a building by the grantor (even a very small proportion) normally counts as occupation for the purposes of the anti-avoidance test and can result in the option to tax being disapplied. From 1 March 2011 all supplies arising from grants made on or after that date will be subject to the new 'two per cent occupation rule'. Under the proposed change a grantor is not treated as in occupation where the conditions of the 'two per cent occupation rule' are met (the conditions largely mirror those of the existing ten per cent rule). The rule works as follows:

- there must be no intention or expectation at the time of the grant that the grantor or a person connected with the grantor will occupy more than two per cent of any building (part or all of which is included in the grant) at any time during the grantor's CGS adjustment period. Where the grantor is in occupation together with a person connected to them, it is the combined occupation that counts towards the two per cent threshold, unless the occupation by either person meets the eligible purposes test in Schedule 10 paragraph 16
- the proportion of the building occupied is to be calculated in relation to the whole of the single building (not just that part that is subject to the grant) or, where the grantor holds an interest in only part of the building, that part in which an interest is held immediately prior to the grant being made (this includes any part of the building in which an interest is held by a person(s) connected to the grantor
- where a number of buildings are included in the same grant, the rule is applied to each building on an individual basis. Where the two per cent threshold is exceeded in relation to any of the buildings, the conditions of the rule are not met. For the purpose of the rule a single building takes its meaning from VATA 1994 Schedule 10 sub-paragraphs 18(4) to (7)

- the rule is not satisfied where the person(s) occupy any land included in the grant which is not a building. However, occupation of land that falls within the curtilage of the building or is used for parking vehicles can be disregarded as long as such occupation is ancillary to the occupation of the building
- for the purposes of calculating the percentage of the building occupied by a particular person the practices set out in the RICS 'Code of Measuring Practice' are to be used. Section 13 of Notice 742A Opting to tax land and buildings contains tertiary legislation setting out detailed rules about how the Code is to be applied. Further details about the method of calculation are given in paragraph 13.8.6 of Notice 742A Opting to tax land and buildings. As with the 10 per cent rule, HMRC will only require evidence of the calculation in cases where the area occupied is close to two per cent (between 0 and 7%)
- like the ten per cent occupation rule, the rule is based on the intention or expectation of the grantor at the time the grant is made and involves a forward look over the ten year period of the CGS. Where it is known at the time of the grant that further grants will be made, the calculation must take account of the occupation that will result from those grants. The test is, however, a one-off test at the time of the grant

5. Occupation by reference to ATMs

The way that occupation by reference to Automatic Teller Machines (ATMs) is treated will also be changed. Currently, occupation which is solely in the form of ATMs is treated as occupation for 'eligible purposes' under Schedule 10 sub-paragraph 16(7). This means it can be ignored for the purposes of the anti-avoidance test. From 1 March 2011 an amendment to paragraph 15 of Schedule 10 will mean that occupation of any building which is solely by way of ATMs will not be treated as occupation for the purposes of the anti-avoidance test. As a result, sub-paragraph 16(7) will not be required and will be repealed.

Revenue & Customs Brief 03/2011

Holidaymakers face end to VAT concessions

HMRC abolish ESCs for caravans and unfitted boats

At the time of year when taxpayers traditionally plan their summer holidays, HMRC have announced forthcoming VAT changes that will affect some popular leisure pursuits.

An extra statutory concession (ESC) on sailaway (unfitted) boats will be abolished on 1 January 2012, when three ESCs concerning VAT on caravans will also come to an end.

The Revenue is currently reviewing its concessions; the majority are to be retained but a minority will be axed for being outside the scope of the department's administrative discretion. It has not been possible or appropriate for the taxman to legislate the ESCs because they are contrary to European law.

From the beginning of next year, VAT-registered businesses will no longer be able to zero rate the supply of sailaway boats to UK residents with the intention of keeping them outside of the EU.

Firms will, however, be allowed to continue to zero rate the supply of the bare vessels to UK residents on the condition that they personally make all arrangements for export.

The three VAT concessions for caravan owners that will cease to apply are:

- the recharge of business rates as outside the scope of VAT;
- zero rate water and sewerage charges where actual consumption cannot be identified; and
- first-time connection to utilities as zero rated for VAT.

HMRC are discussing the impact of the changes with the boat industry and bodies that represent caravanners. Businesses that will be affected are to be allowed a 12-month period of notice before the concessionary treatments formally draw to an end.

VAT and debt collection

This brief explains the HM Revenue & Customs (HMRC) position following the ECJ judgment in AXA UK plc (case ref C-175/09). The case concerned the application of the VAT exemption in Article 135(1)(d) of the EU VAT Directive for:

- 'transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection'
- the Court found that the services in AXA were specifically excluded from the exemption as 'debt collection' and were therefore liable to VAT at the standard rate

Background

AXA UK plc (AXA) is the representative member of a VAT group which includes a company Denplan Limited (Denplan). Denplan operates payment plans on behalf of dentists which offer patients the facility of paying for dental treatment by way of a fixed monthly charge. It was the VAT status of one of the supplies made by Denplan to the dentists in connection with the operation of this plan, ie collecting the payments using the Direct Debit payment method from the patients' bank accounts and accounting to the dentist for any payments received, that was the subject of the ECJ referral.

Both the VAT Tribunal and High Court agreed with AXA and found that there was a separate exempt supply of payment services falling within A135(1)(d). The Court of Appeal, however, decided the issue was not clear in current law and referred the case to the ECJ for a preliminary ruling.

The Court of Appeal asked a number of questions of the ECJ, all focussing in particular on the earlier ECJ judgment in SDC (case ref C-2/95) and the specific functions a business had to be carrying out to bring it within the VAT exemption.

The ECJ released its judgment in AXA on 28 October 2010 and, rather than answering each question individually, decided to consider all the questions together. The Court found that the supply AXA made to the dentists (which it summarised as the collection, processing and onward payment of sums of money due from third parties to the dentists) was specifically excluded from the A135(1)(d) exemption as 'debt collection'.

The HMRC position

The ECJ judgment in AXA now specifically defines what 'debt collection' means for the purposes of the exclusions to the VAT exemption. The ECJ says in paragraph 34 of its judgment that:

- '... it is irrelevant that such service is supplied at the time when the debts concerned become due ...'
- it then goes onto say that the words 'debt collection' in Article 135(1)(d)
- ' ... cover the collection of debts of any nature, without limiting their application to debts which were not paid on their due date.' and also cover ' ... debts which have not yet become due and which will be paid on the due date.'

Following the AXA judgment, therefore, 'debt collection' cannot be seen as applying solely to the service of chasing and recovering overdue payments on behalf of the creditor and all services principally concerned with collecting payments from the person owing them for the benefit of the entity to which those payments are owed (regardless of whether those payments are received before, on, or after their due date) fall within the exclusion to the exemption and are consequently liable to VAT at the standard rate.

Supplies which involve the collection of payments as a minor or ancillary function but which are principally concerned with other payment related transactions that fall within the Article 135(1) exemptions, for example the movement and settlement of payments between bank accounts, will not be affected by the AXA judgment and will continue to fall within the VAT exemption.

What this means for businesses

All payment related services falling within the definition of 'debt collection' as outlined by the ECJ in the AXA judgment are now liable to VAT at the standard rate. If this applies to payment related services supplied by your business and your business has previously received a ruling from HMRC

that those services fall within the VAT exemption (or it has previously been treating its services as exempt in line with HMRC's published policy in this area) then VAT must be applied to those services from the date of this brief.

Revenue & Customs Brief 54/2010

Changes to Capital Goods Scheme: (*Lecture B640 – 32.50 minutes*)

This article explains the changes to the Capital Goods Scheme, and related changes to the partial exemption regulations, that were brought in on 1 January 2011 (as well as some more minor changes that are expected to take effect early in 2011). The following notes comprise:

- an article from *Taxation* magazine (by Mike Thexton) which explains the background to the changes – the history of "*Lennartz* accounting" and why it became necessary for the rules to change;
- the main changes to the capital goods scheme regulations;
- how in particular they impact upon assets with mixed private and business use.

Background

'*Lennartz* accounting' is one of those subjects that only a VAT geek could be interested in. So let me try to get your attention: if you were given the choice between paying £100,000 in tax now and paying the same amount in interest-free instalments over say 20 years, with the possibility that you might be able to stop paying part way through, which would you pick? In the right circumstances, the European Court of Justice insisted that the taxpayer should have that choice. HMRC fought a losing battle over nearly 20 years against the ECJ's generosity, before another judgment and a new Council Directive gave them the opportunity to restrict it. They are still trying to sort out the liabilities of the people who took the instalment option in the meantime, and those who didn't but later claimed that they should have been allowed to.

Herr Lennartz

The *Lennartz* case (ECJ Case C-97/90, 11 July 1991) hardly seems relevant in the UK. A German tax consultant bought a car and did not claim any input tax because he did not use it for business in the year of purchase. The following year he did, and claimed an adjustment under the capital goods scheme (from 'zero' to 'some'). The German authorities refused.

In the UK, of course, the input tax on a car is blocked altogether unless the circumstances are exceptional. A car cannot be a capital item here. So the argument appeared to be of marginal interest. However, the conclusion of the court was striking:

'A taxable person who uses goods for the purposes of an economic activity has the right … to deduct input tax … however small the proportion of business use.'

The ECJ judgment is also unusual in that it gave a full answer to the question that ought to have been asked, rather than the one that was. Often the judges restrict themselves to the exact wording on the paper, leaving open a range of 'what if' problems. Perhaps they do not want to do themselves out of future work. Here, they observed that the capital goods scheme was not appropriate for a change in the level of business against non-business use: Herr Lennartz was asking for a relief to which he was definitely not entitled. However, what he ought to have done was to anticipate the future business application at the time of purchase: instead of regarding the car as a private asset because of its immediate use and asking for some input tax back later on a change of that use, he should have regarded it as a business asset in the first year.

That would lead to the beneficial result that he could claim back the whole of the input tax on the purchase and account for output tax on the private use as if his business was renting the car to himself. 'However small the business use,' the ECJ said: so an asset costing £1m with 1% business use would allow a claim for £175,000 followed by output tax charges of 99% of that sum spread over the life of the asset. That life might be 10, 20, 50 years… effectively an interest-free loan compared to the alternative claim (1% of £175,000 now and forget about the private use).

Choppy waters

HMRC were never happy with the application of this decision. The alternative claim was the normal, sensible way of treating an asset bought partly for business and partly for private use: they regarded the result as fair. They resented giving what amounted to an interest-free loan to the taxpayer, and suspected that the arrangement might be collapsed part-way through with the result that the output tax charges would never reflect the full extent of private use. Through the 1990s they attempted to resist claims for 'the *Lennartz* approach', as it came to be called. In particular, they argued that the ECJ had explicitly referred to 'goods' in its decision, so the case had no relevance to a purchase of services.

In FA 2003, s.22, HMRC attempted to put the matter beyond doubt by inserting a new VATA 1994 Sch.4 para.5(4A): input tax deduction would not be available on the purchase of services relating to land using the *Lennartz* approach. The detailed way in which the restriction was supposed to apply is no longer important: the ink was barely dry on the Finance Bill when the ECJ gave another judgment which showed it was unenforceable.

In *Wolfgang Seeling v Finanzamt Starnberg* (ECJ Case C-269/00), the court ruled (on 8 May 2003) that the *Lennartz* principle applied to construction services for a building that was partly used for private purposes. A German law intended to limit the effect of *Lennartz* was also dismissed as incompatible with the Directive. It seemed reasonable to regard the deemed self-supply as letting of residential accommodation, which appeared to lead to disallowance under the rules of partial exemption instead of non-business use: but the judges held to the principle that exemptions have to fall squarely within the plain words of the Directive to be allowed, and deemed supplies cannot be exempt. Normally the restrictive interpretation of exemptions helps the authorities to raise VAT; here, it had the perverse result of ruling out anti-avoidance legislation.

In July 2005 the ECJ delivered another judgment ruling out the Netherlands' attempt to limit *Lennartz* (*Charles & Charles-Tijmens v Staatssecretaris van Financiën*, ECJ Case C-434/03). The Directive did not allow member states to prohibit a taxpayer from allocating a capital asset wholly to the business (the prerequisite for 'renting it back' for private use). HMRC had confessed their doubts about Sch.4 para.5(4A) in Business Brief 22/03 (November 2003), but now they held their hands up (as the footballers say) and admitted it was ultra vires (Business Brief 15/05, August 2005). Taxpayers were to be allowed to use *Lennartz* for buildings and for construction services; hanging on by their fingernails, the Commissioners asserted that the output tax charges should be calculated by reference to a useful life of no more than 20 years. FA 2007 repealed para.5(4A) 'with effect from 1 September 2007', but it could never have been enforced against any taxpayer.

The tide is high

The high water mark of the *Lennartz* approach in the UK was probably the Tribunal's decision in *Edinburgh Telford College* (VTD 18,913) of November 2004. The chairman decided that *Lennartz* could take precedence over partial exemption: a college with part non-business, part exempt, part taxable use could recover 100% of the input tax up front and then apply the rules of partial exemption to the output tax charges on the deemed self-supplies later.

This was so generous that the taxpayer did not even contest HMRC's appeal to the Court of Session (while continuing to argue about other issues). HMRC celebrated this rare success in Business Brief 5/06: where a building is bought for partially exempt use, the exempt intention prevented 100% recovery.

The tide turns

The tax authorities finally saw a chink of light in *J & S Wollny v Finanzamt Landshut*, ECJ Case C-72/05 (September 2006). Another German tax consultant claimed input tax in respect of a house, 20% of which was let to his business. He reckoned that the output tax should be calculated on the basis of a 50-year life: the monthly clawback would be 1/12 of 2% of the initial recovery. The ECJ held that the authorities were entitled to use a shorter time – although it was not intended for this specific purpose, the capital goods scheme adjustment period (between 5 and 20 years at the member state's choice) was a reasonable and Directive-based principle.

HMRC responded by formalising the rules for *Lennartz* accounting. Regs 116A – 116N ('Goods Used for Non-business Purposes during Their Economic Life') were inserted into the General VAT Regulations with effect from 1 November 2007. The right of taxpayers to deduct input tax up front were recognised, and the output tax charges were fixed at a maximum of 10 years. There were

complex transitional provisions for those who had acquired assets before November 2007 and had started accounting using a different life.

Capital sideshow

Two more decisions which appeared to muddy the business/non-business waters were handed down by the ECJ in June 2005 (*Waterschap Zeeuws Vlaanderen v Staatssecretaris van Financiën*, ECJ Case C-378/02) and March 2006 (*Uudenkaupungin kaupunki v Lounais-Suomen Verovirasto*, ECJ Case C-184/04). In the first, a public body bought a capital item and could not recover input tax because it was not a taxable person at the time. It later changed its status and sold the building. The court ruled that it could not use the capital goods scheme to recover any of the original VAT suffered on the cost of the building: the scheme adjusts input tax, and VAT incurred by a non-taxable person is not input tax.

In the second, another public authority opted to tax some buildings more than six months after buying them. The Finnish law did not allow it to recover the VAT on the original costs, but the ECJ held that it was entitled to use the capital goods scheme. The critical difference was that it was accepted that the Finnish authority had been acting as a taxable person when it bought the buildings, because it rented them out to third parties.

Out in the wash

Just when it seemed that *Lennartz* accounting was established and understood, the ECJ turned everything on its head. In *Vereniging Noordelijke Land-en Tuinbouw Organisatie v Staatssecretaris van Financien* (C-515/07) – usefully abbreviated to *VNLTO* – the judges pointed out a limitation on the application of *Lennartz* that no-one had previously noticed. Given that the German, Netherlands and UK authorities (at least) had been trying hard for years to restrict *Lennartz* recoveries, this surely let to some hair-tearing and gnashing of teeth.

Lennartz recovery is based on a 'chicken and egg' problem. Input tax has to be attributed to a taxable supply. Private use is deemed to be a taxable supply. So the future private use, together with the future actual business use, justifies 100% recovery: even if the split is 99:1, both parts constitute taxable supplies.

VNLTO is an agricultural sector trade organisation. It claimed to apply *Lennartz* not in respect of capital assets but in relation to general expenditure. It is not obvious what benefit would arise, as there should be an immediate balancing output tax charge – but that was what they wanted. The judges pointed out that the self-supply charge (now in Article 16 Directive 2006/112/EC) depends on 'the application by a taxable person of goods forming part of his business assets for his private use or for that of his staff, or their disposal free of charge or, more generally, their application for purposes other than those of his business'.

The argument in the UK has always assumed that 'non-economic use' (for example activities of a charity that do not involve making supplies for a consideration) fell within this, but the judgment shows that they do not. Private use must be completely unconnected with the taxable entity's operations – Herr Lennartz's private use of the car was to go shopping; Herr Wollny had breakfast in the other part of his house. VNLTO did not have any private use in that sense. The expenditure could not be related to a taxable activity – whether actual or deemed – and so the organisation never had any entitlement to input tax.

Full ebb

While everyone digested the consequences of *VNLTO*, the European Council approved a technical VAT Directive (2009/162/EU) which took effect on 15 January 2010 and was required to be incorporated in the legislation of member states to take effect no later than 1 January 2011.

Among the amendments to the 2006 VAT Directive was a new restriction on input tax deduction (see box).

New article 168a

1. In the case of immovable property forming part of the business assets of a taxable person and used both for purposes of the taxable person's business and for his private use or that of his staff, or, more generally, for purposes other than those of his business, VAT on expenditure related to this property shall be deductible in accordance with the principles set out in Articles 167, 168, 169 and 173 only up to the proportion of the property's use for purposes of the taxable person's business.

By way of derogation from Article 26, changes in the proportion of use of immovable property referred to in the first subparagraph shall be taken into account in accordance with the principles provided for in Articles 184 to 192 as applied in the respective Member State.

2. Member States may also apply paragraph 1 in relation to VAT on expenditure related to other goods forming part of the business assets as they specify.

In effect, this removes the *Lennartz* choice for immoveable property used for partly business, partly private purposes. Articles 184 to 192 cover the capital goods scheme: as established in the *Waterschap* case, this has previously been restricted to adjusting initial input tax recovery for changes in the proportion of exempt and taxable use of specific assets.

Going, going…

HMRC took nearly a year to respond to *VNLTO*. They may have been too busy banging their departmental heads against the nearest wall, or they may have been waiting for the Technical Directive. On 22 January 2010, Revenue & Customs Brief 02/10 announced a change in approach. The 2007 regulations would now only be available where assets were used 'privately' and not for non-economic purposes that were nevertheless part of the activities of the taxpaying entity.

Those taxpayers who had already started operating *Lennartz* accounting in circumstances in which it would no longer be allowed were offered a choice: continue until the end of the economic life, or go back and unwind everything. As the *Lennartz* route would have been chosen because it was better for cash flow, this ought to be an easy decision.

Between the lines of the Brief, it was possible to detect HMRC's anticipation of the 'have and eat cake' approach: as taxpayers are entitled to rely on the UK law, or else to claim their EU law rights if the UK law is inconsistent with the Directive, it would be possible to argue for the best of both worlds. The input tax was claimed in the past in accordance with UK law and practice; we now know that the output tax should not be accounted for because the non-business, non-private use does not give rise to a self-supply. So we will keep the input tax and stop paying output tax. Suffice it to say that HMRC will resist this argument; it would be difficult to convince anyone that it was morally right, even if there is a possible justification in the law.

Gone?

The Budgets of both March and June 2010 included announcements about changes to the law to reflect the Technical Directive which are to take effect from 1 January 2011. These did not make it into either of the first two Finance Bills, but they will be in force on time.

Meanwhile, HMRC have published their 'internal theme narrative' guidance on the many different types of claim they have received for VAT overpaid and underclaimed in the past (so-called 'Fleming claims'). The latest version of the guidance includes a section on *Lennartz* claims: presumably organisations with part non-business use of buildings have put in claims for VAT incurred in the 1990s, while HMRC still refused to accept *Lennartz* accounting. The guidance explains that HMRC will apply *VNLTO* to such claims, and includes a 'standard rejection letter'.

HMRC are taking advantage of the option in the Technical Directive to rule out *Lennartz* accounting on other assets as well as land. In summary, the effect of the changes is:

- *Lennartz* accounting will be restricted to assets with part private use, not non-economic use, in accordance with *VNLTO*;
- *Lennartz* accounting will no longer be allowed for expenditure on real estate, ships or aircraft, even if they have part private use, in accordance with the Technical Directive;

- private use of these types of asset by a taxable person or the person's staff does not constitute business use for the purposes of VAT;
- existing *Lennartz* arrangements will be subject either to total reversal or follow-through for the remainder of the life of the asset, at the trader's choice;

VAT incurred on non-business activities will be capable of categorisation as input tax under a new VATA 1994 s 24(6)(a), so that it can be adjusted if business use of the expenditure increases in future. Up to now, expenditure could only be adjusted under the capital goods scheme if it constituted input tax (i.e. business-related) from the outset.

What's left?

Sadly, the choice I offered in the opening paragraph is no longer available to many people. Given that cars are ruled out by other regulations, there are few substantial assets on which 'private' use in the *VNLTO* sense is possible. Until those German tax consultants can come up with something else to run past the European Court of Justice…

Changes to capital goods scheme and PESMs

HMRC have issued a Brief containing a technical note and draft amending regulations to implement the EU VAT Technical Directive. This partly affects "*Lennartz* accounting" (see 1.3/4 below) but there are also more general changes to the CGS, including:

- the inclusion of ships and aircraft costing £50,000 or more;
- the simplification of reg.113, which used to contain a list of different types of expenditure on buildings but which now lists separately 6 classes of asset then describes the capital expenditure that will be covered by the scheme;
- the removal of reg.115(3), which restricted a sale adjustment in the taxpayer's favour to the amount of output tax charged on the sale – HMRC regard this as unnecessary because regs.115(3A) and (3B) give them the power to restrict the total input tax recovered on the item to that amount anyway;
- enactment of the concession which allows a trader who becomes registrable because of an option to tax to recover VAT in accordance with a calculation similar to the CGS;
- clarification of the interaction between grouping and the CGS (the representative member is treated as owning all the CGS items in the group).

HMRC are also proposing to finish the project on simplification of the partial exemption rules which has been in progress for the last three years. The last phase includes:

- introduction of a new right of taxpayers to agree a single method which will deal with taxable, exempt and non-business VAT in one calculation (currently a special method is strictly only permitted once the non-business VAT has been extracted);
- introducing a de minimis limit below which changes in the use of a CGS asset will be ignored.

The de minimis limits are as follows:

- the adjustment percentage is 1% or less, or
- the total VAT bearing capital expenditure on a capital item of a description falling within regulation 113 is £1,000,000 or less and the adjustment percentage is 10% or less, or
- the total VAT bearing capital expenditure on a capital item of a description falling within regulation 113 is £10,000,000 or less and the adjustment percentage is 5% or less.

R&C Brief 47/10; SI 2010/3022

Changes to the law

The last Finance Bill of 2010, published on 1 October, contains provisions to amend the *Lennartz* rules. Clause 19 introduces Schedule 8, which amends the *Lennartz* procedure, under which a business may initially recover VAT in full on the purchase of an asset even where there is an element of non-business use, is to be changed.

Amendments to VATA 1994 will:

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

The capital goods scheme will be amended by regulations to take into account changes in the business/private use of an asset (see below).

As a revenue protection measure, output tax will continue to be due in respect of supplies for which credit was allowed under the *Lennartz* mechanism (assuming that the trader does not choose to reverse the *Lennartz* accounting that has been commenced under the old rules).

http://www.publications.parliament.uk/pa/cm201011/cmbills/072/11072.i-iii.html

HMRC have issued a Brief containing a technical note and amending regulations to implement the new rules in accordance with the EU VAT Technical Directive. To deal with the issue of private use:

- the capital goods scheme is amended to include "VAT-bearing capital expenditure", so it is no longer dependent on the VAT incurred being input tax at the point of acquisition;
- it is extended to include ships and aircraft costing £50,000 or more, but land and buildings still have to cost at least £250,000;
- "the adjustment percentage" is redefined to mean the difference (if any) between the extent, expressed as a percentage, to which the whole or part as appropriate of the capital item was used or to be used for the making of taxable supplies at the time the original entitlement to deduction of the input tax was determined and the extent to which the whole or part of it as appropriate is so used in a subsequent interval;
- a capital item that is purchased before the person is registered will be considered to have started an adjustment period when first used, and adjustments will be made for any intervals which finish after the trader is registered – at the same time, it is clarified that expenditure on capital items cannot qualify as pre-registration expenditure under reg.111, because it will only give rise to entitlement under this new provision;
- "the original entitlement to deduction" is redefined to mean the entitlement to deduction under sections 24 to 26 of the Act and regulations made under those sections.

The regulations on *Lennartz* accounting (reg.116B) are amended to exclude any expenditure incurred on or after 1 January 2011.

Regs. 108 and 109 are also amended to allow a payback or clawback to occur where there is a change from a taxable intention to non-business use or vice versa (by defining "exempt supplies" for the purposes of those regulations as including a reference to non-business activities that give rise to an amount of non-business VAT).

R&C Brief 47/10; SI 2010/3022

More detail on the new rules

HMRC issued a second Brief to explain the new rules which restrict "*Lennartz* accounting". It outlines the background to the changes to the Capital Goods Scheme that took effect on 1 January 2011, and sets out the following summary of the remaining application of *Lennartz*:

> Lennartz accounting is now available only in very limited circumstances where, for assets other than land property, ships and aircraft, the goods are used in part:
>
> - for making supplies in the course of an economic activity that give a right to input VAT deduction (broadly, taxable supplies, supplies that would be taxable if made in the UK or certain financial and insurance supplies to non-EC customers);

- in part for the private purposes of the taxpayer or his staff or, exceptionally, for other uses which are wholly outside the purposes of the taxpayer's enterprise or undertaking.

Taxpayers who have embarked upon Lennartz Accounting in relation to an asset before 1 January 2011 must continue to operate it in respect of that asset. However, for land and property, ships and aircraft any VAT incurred on or after this date is recoverable only to the extent that the asset is used to make taxable supplies or other business supplies carrying input tax credit.

As a transitional measure, following a change in policy arising from an ECJ decision, many taxpayers who had incorrectly been permitted to use Lennartz Accounting were able to continue using this mechanism, unless they chose to unravel the Lennartz Accounting completely (see Revenue & Customs Brief 02/10). From 1 January 2011, any VAT incurred on land and property, ships and aircraft is recoverable only to the extent that the asset is used to make taxable supplies or other business supplies carrying input tax credit. From 1 July 2011, taxpayers who were incorrectly permitted to use Lennartz Accounting will be able to unravel only where normal assessing time limits still apply to the original claim.

Revenue & Customs Brief 53/2010

Contributed by Mike Thexton