CONTENTS

PERSONAL TAX **2**
Company car or own car? (***Lecture P656 - 14.41 minutes***) **2**
Domicile and residence issues (***Lecture P657 - 9.27 minutes***) **4**
No compassion from HMRC in residence case **6**
The Ten Day Residence Test **(Lecture P658 - 12.57 minutes)** **7**
IT contractor wins another IR35 case! **8**
Pilot training costs **9**
Ferrari – a company car? **9**
Transactions in securities (FA 2010) (***Lecture B656 – 14.17 minutes***) **10**

CAPITAL TAXES **12**
Reversal of Hastings-Bass (***Lecture P659 14.17 minutes***) **12**
Trust management expenses (***Lecture P660 – 8.40 minutes***) **14**

ADMINISTRATION **16**
New task forces to tackle tax dodgers **16**
13 years' of assessments **16**
Asking for help **17**
Online filing for year-end returns **17**
Failure to pay NIC due to neglect of directors **18**

BUSINESS TAXES **20**
Were property losses those of a trade? **20**
Deductibility of counselling expenses **21**
Was sponsorship expenditure "wholly and exclusively" for the trade? **23**
Income recognition and negligent conduct **24**
Dilapidations: Correct Tax Treatment **(Lecture B657 – 10.11 minutes)** **26**
Partnerships buying software **28**
Associated companies (***Lecture B658 – 15.42 minutes***) **28**
Planning with the reduced Annual Investment Allowance **30**
Corporation tax on gains (Part 2) (***Lecture B659 – 18.14 minutes***) **31**

VALUE ADDED TAX **38**
Online returns **38**
Late registration (old rules) **38**
Time limits **38**
Old penalties updated **39**
Late notification of option to tax? **39**
VAT toolkits: technical note (***Lecture B660 – 16.59 minutes***) **40**

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Personal Tax

Company car or own car? (*Lecture P656 - 14.41 minutes*)

Statutory system for employee using own car

Statutory authorised mileage rates apply as under, all based on environmental protection:

Car

- first 10,000 miles 45p from 6/4/11
- excess 25p

Motorcycle

24p

Bicycle

20p

Car sharing

Employer can pay 5p per mile free of tax and NIC for each passenger carried, provided it is a fellow employee making the same business trip. This is being extended to volunteer drivers.

If the employee receives less than the statutory rate, tax relief is claimable on the difference but that does not apply to the car sharing part. If the employee receives more than the statutory rate, the excess is taxed.

The statutory rate supposedly reflects loan interest and depreciation, so no separate claim is possible.

Clearly the system penalises high business mileage employees driving a car of over 2 litres. Examples of cost per mile from *What Car?* based on 3 years/36,000 miles including depreciation, maintenance, fuel and vehicle excise duty (but excluding insurance (which could easily add between 4p and 10p per mile) are below:

Car	Cost per mile
AUDI A3 1.4	43.6p
CITROEN C3 1.4	47.1p
FIAT 500	30.9p
FORD MONDEO	50p
JAGUAR XF	73.2p
RANGE ROVER SPORT	152.4p
RENAULT CLIO	33.5p

A self-employed person can use these rates as well if his annual turnover does not exceed the VAT registration threshold. He has the option to claim actual business use expenses. The same situation applies to volunteer drivers to calculate the taxable profit on mileage allowances received from hospitals, social service agencies and other voluntary organisations.

The calculations

There is software on the market to assist. Where the employer is an OMB it should be straightforward to identify which is the better option in the particular circumstances. For other employers the answer is very much dependent upon the amount of the car allowance on offer where the employee uses his own car. It should be of such an amount that it covers some of his private travel as well as business travel.

The clear conclusion is that a company car is going to be more tax efficient than a car allowance in either of the following situations:

Car has low CO_2 emission levels and the level of business mileage is low resulting in effectively a low tax charge per private mile

Honda Jazz 1.2 S

CO2 emissions = 125 g/km

List price = £10,990

Tax on 15% for 2011/12 = £1,648 @ say 40% = £659

Private mileage	***Tax per private mile***	***real cost****
8,000	*8.23p*	*30.1p*
10,000	*6.59p*	*30.1p*
15,000	*4.39p*	*21p*
20,000	*3.29p*	*16p*

** based on "What Car" figure for 12,000 miles per annum total mileage over 3 years, scaled down for higher mileage*

Level of business mileage is high, resulting in a tax deductible car allowance which does not meet the true business costs

Jaguar XF 3.0 V6

CO_2 emissions = 249 g/km

List price = £29,900

Tax on 35% for 2011/12 = £10,465 @ say 40% = £4,186

Business mileage	***Tax allowance on***	***Real cost****
10,000	*£4,500*	*£7,320*
20,000	*£7,000*	*£12,000*
30,000	*£9,500*	*£15,000*

**based on "What Car?" figure for 12,000 miles per annum total mileage over 3 years = 73.2p per mile, scaled down for higher mileage*

In the illustrations, clearly the Honda Jazz as a company car would result in a much lower tax charge per private mile than the real cost if the car was owned privately. The Jaguar is basically not an attractive option as a company car, but may nevertheless be better than private ownership where business mileage is high and the tax allowance is less than the real cost.

The company car

Within the calculations account must be taken of forthcoming reductions (albeit modest reductions) to the taxable benefit from 2013/14 as announced in Clause 51 Finance (No.3) Bill 2011.

The taxable benefit appropriate % will be reduced by 1% for a vehicle with CO2 emissions between 95 g/km and 220 g/km. The tax charge on cars with up to 75 g/km of CO2 emissions remains at 5% of list price and at NIL if zero emissions.

Contributed by Gerry Hart

Domicile and residence issues (*Lecture P657 - 9.27 minutes*)

Domicile review

The Coalition Government stated in June 2010 that it would review the taxation of those who enjoy an often favourable tax status as a non-UK domiciled individual. New measures announced in the 2011 Budget will see a change to the tax regime for those non-UK domiciled individuals who benefit from the remittance basis rules.

Previously, if a non-domiciled, but UK resident individual opted to claim the remittance basis, a flat charge of £30,000 was payable where that individual had resided in the UK for 7 of the previous 9 tax years. The Chancellor has announced that an increased rate of £50,000 will be payable for those individuals who have enjoyed UK residence for 12 years or more.

However, proposals were also announced to review the tax charges that arise where non-domiciled individuals bring their foreign income (or capital gains) into the UK, with a view to removing these charges where foreign funds are subsequently invested in UK businesses.

A consultation period shall follow, in June 2011, with the intention of introducing these reforms from April 2012.

The key here is of course to avoid the law of unintended consequences. There is a fine line between putting off the wealthy from settling in the UK - especially those who will set up businesses here - and sending out mixed messages on the means that high net worth individuals use to mitigate their tax bill.

Domicile rules today

An individual is normally domiciled in the country that they regard as their permanent 'home'. Temporary residence does not alter domicile. Unlike residence, domicile cannot be shared - each individual can only be domiciled in one place at any one time. There are three different means of establishing domicile.

Domicile of origin

This is the default domicile and is the individual's father's domicile at the time of the individual's birth in the case of a marital child. A non-marital child, or a child born after the father's death, takes the domicile of the mother.

Domicile of dependence

A child under the age of 16 will change its domicile if its parents change theirs. When such an individual reaches 16 years of age they become capable of adopting a domicile of choice.

Domicile of choice

An adult can renounce his or her domicile of origin. However, it can be extremely difficult to establish a new domicile.

As a minimum, an individual would have to leave the UK and go to another country with the purpose of living there permanently. The intention to reside outside the UK would need to be demonstrated by positive actions.

Income tax

The income tax treatment depends on:

- the type of income
- whether a person is resident in the UK or not
- if non-domiciled, how long they have been resident in the UK.

Generally, if an individual is resident and domiciled in the UK, they are liable to income tax on their worldwide income.

Special rules apply to the foreign income received by individuals who are resident in the UK but are non UK domiciled or are not ordinarily resident in the UK.

Non-domiciled or not ordinarily resident individuals

Until 5 April 2008 non-domiciled or not ordinarily resident individuals were taxed on the remittance basis: broadly, they were taxed on overseas income and gains brought into the UK.

From 6 April 2008 non-domiciled or not ordinarily resident individuals are generally taxed for any given tax year on their worldwide income and capital gains unless:

- the unremitted foreign income and gains for that year are under £2,000, or
- they have no UK income or gains or they have UK income or gains of no more than £100 of investment income in that year which has been taxed in the UK, and remit no foreign income or gains and
- they are under 18 throughout the tax year, or
- the individual has been UK resident in not more than six of the nine tax years immediately preceding that year, or
- they make a claim to be taxed on the remittance basis

Where a claim is made for the remittance basis to apply, the taxpayer is not entitled to the personal allowance or annual capital gains exemption for that year.

Furthermore, if the individual has been UK resident in at least seven of the nine tax years immediately preceding that year and is aged 18 or over, they must pay the remittance basis charge.

The decision to claim the remittance basis can be made annually.

Income arising in the UK

Income arising in the UK, such as earnings from duties performed in the UK, will generally be subject to income tax in the UK.

Income arising outside the UK

Items marked as 'remittance basis' in the tables below are taxable in full unless the individual is entitled, or makes a claim, to use the remittance basis, paying the annual charge, where appropriate.

Employment income from an overseas employer is liable to UK income tax as follows:

R and OR status of employee	Duties performed in the UK	Duties performed partly outside the UK	Duties performed wholly outside the UK
R and OR	Liable	Liable	Liable, unless employee is non-UK domiciled in which case remittance basis can be claimed
R but not OR	Liable	Remittance basis	Remittance basis
NR	Liable	Not liable	Not liable

Income from trades and professions carried on and controlled outside the UK and income from overseas investments are liable to UK income tax as set out in the table below:

	UK domicile	Non-UK domicile
R and OR	Liable	Remittance basis
R but not OR	Liable	Remittance basis
NR	Not taxable	Not taxable

These general rules may be varied by the terms of a double taxation agreement.

Capital gains tax

Overseas capital gains of non-domiciled or not ordinarily resident individuals are taxable in full unless the individual is entitled, or makes a claim, to use the remittance basis, paying the annual charge, where appropriate.

If a UK resident individual leaves the UK for less than five years, chargeable gains made while non-UK resident may be assessed to UK capital gains tax in the tax year in which that individual returns to the UK. This provision does not apply to assets acquired and also disposed of during the non-resident period, unless the asset(s) disposed of were derived in some part from assets the individual held while resident or ordinarily resident in the UK. Accordingly, careful planning is called for prior to leaving or coming to the UK.

Residency

Whether or not an individual is resident in the UK has a significant impact on the potential exposure to UK tax. However, the UK still lacks a robust statutory test to provide certainty on an individual's residence status. This has become an increasing problem with more people becoming internationally mobile and a stream of tax cases raising confusion in this area from Gaines-Cooper through to Grace.

However, it was announced in the 2011 Budget that the Government intend to consult on the introduction of a statutory tax test for residency. It is anticipated that this will be issued in June 2011.

In the meantime, HM Revenue & Customs (HMRC) has its own guidance on the matter, in the form of ‘HMRC6’, which replaced the leaflet IR20. This was recently subject to revision, following the outcome of several high profile cases. The lesson to be learnt from these cases is that the guidance for a non-resident individual will only apply if, in fact, residency is broken in the first place. In other words, it is essential that a distinct break from the UK can be evidenced, before adopting any guidance set out for maintaining non-resident status.

Contributed by Francesca Lagerberg

No compassion from HMRC in residence case

The First-tier Tribunal has dismissed a taxpayer’s appeal that he became resident in the UK as a result of compassionate leave, resulting in him being taxable on all his income.

Mr Ogden was a resident of Jersey and employed by his own company, WorldPay, which was later taken over by RBS.

Mr Ogden’s son became critically ill with cystic fibrosis and needed to receive treatment in the UK. He took compassionate leave from his employer to spend more time by his son’s side throughout the treatment.

After asking HMRC, he was assured that the 91-day rule would apply and a number of days would be deducted due to "extenuating circumstances". On the death of his son and subsequent return to Jersey he was instantly dismissed from his job.

HMRC then assessed him on the full amount of his termination payment on the basis that he had been resident in the UK during the relevant tax year – spending more than 183 days in the UK. The 183-day rule is in fact the "actual test" applied and no days could be deducted due to "extenuating circumstances".

The Tribunal found that HMRC had correctly issued the amendment to the taxpayer's return and his appeal was dismissed.

Nicholas Ogden (TC01077)

The Ten Day Residence Test (Lecture P658 - 12.57 minutes)

General principles

It has always been accepted that if somebody is not a resident of the UK, they will not be expected to pay income tax except in relation to earnings from sources in this country.

There will be occasions where people are not resident in any country because they flit around the world, and there are also some countries that do not levy income tax.

The issue that has never been satisfactorily resolved is what happens when somebody ceases to be resident in the UK as a result of leaving to work overseas.

If an individual emigrates permanently, cuts all of their UK ties and never returns, that is simple and uncontroversial. In other situations case law helps to provide interpretations, but now HMRC has stepped in to provide their own interpretation and guidance in this specific area.

Scope and consequences

The interpretation that has now been highlighted will only affect those who leave the UK to take up full-time employment overseas. It should not make any difference to anyone leaving the country permanently or indefinitely.

If somebody is resident in the UK for income tax purposes, they will be obliged to pay UK tax on the basis of their worldwide income, rather than merely their income arising from duties in this country. This extends to investment income as well as earnings.

This will be particularly significant for somebody living in a country without a double taxation treaty with the UK, and even more so where that country has a very low income tax rate or does not levy income tax at all.

New interpretation

HMRC will generally accept that working in the UK for fewer than ten days in a year will not by itself prevent an individual claiming they have made a break with the UK because they are working full-time abroad.

If more days than this are worked in the UK, whether an individual is working full-time abroad will depend upon their particular circumstances.

HMRC has confirmed that where somebody spends time in the UK carrying out duties that are merely incidental to their overseas employment, these will not be counted.

Incidental duties

HMRC has also updated the *Employment Income Manual*, section EIM40204, which contains four examples of situations where duties either are or are not incidental.

To summarise briefly, time spent on training courses or reporting back to a head office will not be regarded as substantive, while attendance at board meetings, even by teleconference or its equivalent, will be substantive by definition and therefore will count towards the ten days.

Most worrying of all is the last example, that of a courier for a tour operator who visits many countries in the course of the employment. Visits to the UK, however few and however short, are of the same importance to the job as visits to other countries.

As a result, they cannot be regarded as merely incidental.

Examples

Let's consider some examples of how the rule could work in practice.

- Jane works for an overseas charity providing relief in Africa. She spends the vast majority of her time abroad, but returns to the UK to report back to management three times a year for one-week periods. As Jane spends no time working substantively in the UK, she will not be resident.
- Joan is a company director based in Dubai. She attends day-long board meetings in the UK once a month. Since she spends 12 working days in the UK each year, she will continue to be UK tax resident.

Immediate action required

All employers with employees who might be affected and all affected individuals should keep a careful record of all substantive working days in the United Kingdom and ensure that this does not reach ten days in any tax year.

In addition, where there might be any question as to whether working days are substantive or incidental, it might be safest to avoid work in the UK or, alternatively, avoid coming here at all.

Problems for employers

For any business that employs individuals who could be subject to a reinterpretation of their residence status, there could be considerable uncertainty.

In theory at least, if someone is resident in this country it will be necessary to deduct PAYE and NIC from their salary and account for this to HMRC.

Where an NT ('no tax') coding has been obtained in good faith, this should be all that is required.

However, it is by no means unknown for employers to establish their own unofficial equivalent to an NT coding, merely neglecting to account for any UK tax in respect of overseas employees.

If it transpired at some future date that those individuals were UK resident throughout their period of absence, it would be possible for the taxman to come knocking on the door demanding all of the underpaid tax from the employer going back to the date of departure.

Statutory Residence Test

Provided that the many impediments to the introduction of a statutory residence test can be overcome by early next year, the position will become 100% clear as soon as FA 2012 becomes law.

Contributed by Philip Fisher

IT contractor wins another IR35 case!

IT contractor Elaine Richardson, trading as ECR Consulting, recently emerged victorious from an IR35 case that could have cost her £50,000.

In their ruling, the tribunal judges concluded, "It is clear to us that ECR is a genuine business and therefore not a target of the IR35 legislation."

After it decided Richardson was a disguised employee through an engagement with Vertex Data Science, HMRC handed her a £50,000 tax assessment in November 2005. As a member of the Professional Contractors Group (PCG), she was covered by tax investigation insurance and was represented by Accountax Consulting.

The tribunal applied three status tests - mutuality of obligation, substitution and control - to determine the nature of her working relationship with Vertex and concluded: "ECR operates from a dedicated business area at her home. It has a company domain and website. ECR advertises its

services and is a member of the PCG. It has retained reserves and invested in development and has over the years taken on fixed price work for a variety of clients."

In a press release on the case, the PCG argued that the tribunal's focus on Richardson being in business on her own account could signal a shift of thinking by tax tribunals. "The classic tests of employment and IR35 status – control, substitution and mutuality of obligation – are increasingly irrelevant in today's knowledge economy, and can no longer reflect modern flexible working patterns," the group said.

Accountax Consulting's Matt Boddington, who represented ECR Consulting at the tribunal, commented: "What is particularly pleasing about this judgement is that the tribunal had their commercial heads on, and understood that contracting through a single person limited company is a prudent and sensible method of providing freelance services, and not just about disguising employment."

Accountingweb, 16 May 2011

Pilot training costs

The taxpayer, a UK citizen, had been resident in South Africa for some years. While there he had paid for and obtained a South African commercial pilot's licence.

He wished to return to the UK, but to continue as an airline pilot, he needed to carry out additional training to become qualified in the UK under the Civil Aviation Authority (CAA). He undertook the required courses, and included the relevant expenses and some travel expenses in his tax return.

HMRC allowed the deduction in part. The taxpayer appealed.

The First-tier Tribunal considered the expenses claimed in three groups. Group A included a distance learning course which the taxpayer carried out while still in South Africa.

The tribunal acknowledged that the course would have helped the taxpayer gain the required knowledge to help him pass the CAA examinations, but said there was no evidence that the fees were paid for any registration, certification, or licensing. Nor were they fees paid to obtain or renew a CAA licence.

The essential aspect of the course was training. They did not satisfy the definition of 'professional fee for the purposes of para 11 of the Table in ITEPA 2003, s 343(2) and were therefore not allowable.

The items in group B included equipment and aids to learning which may have helped the taxpayer obtain his CAA licence, but could not be regarded as fees in s 343.

With regard to the expenses in group C, these were all of a personal nature and therefore not allowable.

Finally, the travel expenses in group D did not come under s 343, but should be claimed under s 337.

However, under that section, the expenses could only be allowed where the employee was obliged to incur them necessarily in the performance of the duties of the employment. This was not the case in this instance.

The taxpayer's appeal was dismissed.

Philip E Edgar (TC1109)

Ferrari – a company car?

The taxpayer was a director of Huntington Antiques Ltd. During an enquiry into the tax affairs of that company, HMRC became aware that that company owned two cars.

They concluded that as the taxpayer was a director-employee of the company, the cars were made available to him by reason of his employment.

They raised assessments, which included car benefit in respect of two cars, a BMW and a Ferrari.

The taxpayer appealed.

He explained that the Ferrari had been bought by the company for use on tracks or circuits only and could not lawfully be used on the public highway. Its sole use was as a marketing tool to entertain clients.

However, it was decided to sell the car in 2001, although no actual sale took place until 2005.

HMRC argued that the Ferrari was available to the taxpayer by reason of his employment.

After surveying the evidence, the First-tier Tribunal decided that the taxpayer had made no personal use of the Ferrari and that it was only used as a marketing tool. It would be artificial to regard the car, in those circumstances, as being 'made available' to the taxpayer.

The taxpayer's appeal was allowed.

Michael Golding (TC1097)

Transactions in securities (FA 2010) (*Lecture B656 – 14.17 minutes*)

This article covers transaction in securities legislation that applies to individuals and trustees. There is parallel legislation which applies to corporate shareholders which will not be covered in this session.

There has been anti-avoidance legislation in connection with transactions in securities since 1960, to prevent shareholders from gaining an income tax advantage from turning income into capital. There have been a number of cases that refine the application of the legislation, and the legislation has been amended over the years. In July 2001 HMRC published a consultation document, Simplifying Transactions in Securities, with the aim of clarifying existing legislation setting out the circumstances where the anti-avoidance legislation should apply.

Where a transaction is caught under the legislation, HMRC will issue a counteraction notice to ensure that income tax they regard as having been avoided is collected. Broadly, the transaction in question will be taxed as if it were a distribution by the company to the shareholder concerned. The individual or trustee will have a higher rate income tax liability, as appropriate, on the quantum of the transaction that is treated as a distribution.

What is a transaction in securities?

A transaction in securities is defined in section 684(2) ITA 2007 as "a transaction of whatever description, relating to securities, and includes in particular-

(a) the purchase, sale or exchange of securities,
(b) issuing or securing the issue of securities,
(c) applying or subscribing for new securities, and
(d) altering or securing the alteration of the rights attaching to securities."

Laird Group plc v CIR (2003 STC 1349) held that the declaration and payment of a dividend was not a transaction in securities.

CIR v Joiner (1975 STC 657) considered the situation of a company that went into liquidation. This case concluded that a straightforward liquidation was not a transaction in securities, but it the liquidation was coupled with the transfer of the company's business to another company under substantially the same ownership this would be a transaction in securities.

What is an income tax advantage?

Income tax advantage is defined in section 687 ITA 2007. Basically, this section compares the income tax which would be payable on the "relevant consideration", meaning the assets of the company that could be distributed by way of dividend (in essence distributable reserves), with the capital gains tax payable (if any) in respect of that relevant consideration. Relevant consideration in respect of any shareholder is limited to the maximum amount that could possibly be paid to that person in any circumstances.

The amount of the income tax advantage is the excess of the income tax liability over the capital gains tax liability, if any.

This means that an income tax advantage cannot arise where the company in question does not have any distributable reserves.

When does a person receive a counteraction notice?

Section 684 ITA 2007 looks at the situations in which an individual becomes liable to counteraction of an income tax advantage, and applies where:

(a) the person is a party to one or more transactions in securities,
(b) the circumstances are covered by section 685 and not excluded by section 686,
(c) the main purpose or one of the main purposes of the person in being a party to a transaction in securities is to obtain an income tax advantage, and
(d) the person obtains an income tax advantage in consequence of the transaction or the combined effect of the transactions.

Section 685 applies where Condition A or Condition B is met.

Condition A is where a person receives relevant consideration in connection with

(a) the distribution, transfer or realisation of assets of a close company,
(b) the application of assets of a close company in discharge of liabilities, or
(c) the direct or indirect transfer of assets of one close company to another close company,

and does not pay income tax on the consideration (apart from under a counteraction notice).

Condition B is that

(a) the person receives relevant consideration in connection with a transaction in securities,
(b) two or more close companies are concerned in the transaction or transactions in securities, and
(c) the person does not pay income tax on the consideration (apart from under a counteraction notice).

Section 686 provides an exclusion where there is a fundamental change in ownership of a close company broadly where, as a result of the transactions at least 75% of the ordinary share capital, entitlement to distribution or votes are held by a person who is not and has not been connected in the two years prior to the transaction.

Application for clearance

A person can apply for advance clearance under section 701 ITA 2007, giving particulars of the transactions, seeking confirmation that HMRC are satisfied that no counteraction notice ought to be served in respect of the proposed transactions.

Contributed by Paul Howard

Capital Taxes

Reversal of Hastings-Bass (*Lecture P659 14.17 minutes*)

The rule in *Hastings-Bass* has been overturned by the Court of Appeal in the combined cases of *Pitt v Holt* and *Futter v Futter*. As a result, the scope for trustees trying to remedy the disastrous consequences of their mistakes is now considerably reduced.

Hastings Bass

Hastings Bass deceased [1974] STC 211 [1] concerned Peter Robin Hood Hastings-Bass (Captain Hastings Bass) who had a son, William Edward Robin Hood Hastings-Bass. Captain Hastings-Bass had a life interest in a settlement set up in 1947, the year before William's birth, in which William had a subsequent interest.

However, the death of the captain would have meant significant death duties were payable, which could be reduced if his son were advanced a life interest over some of the trust fund.

The captain's sister had set up a trust in 1957 with a life interest for William and subsequent trusts for his children, if he had any. It was thought convenient to advance the property from the 1947 settlement to be held on the trusts of the 1957 settlement, and this was done in 1958.

The problem with this was the law as it then stood regarding perpetuities.

While William was alive at the time of the 1957 settlement, he was not at the time of the 1947 settlement, and it was the 1947 date which was relevant. When the captain died in 1964, the Inland Revenue claimed that the advancement of capital was ineffective, and that the captain still held a life interest at his death.

The trustees therefore took proceedings against the Inland Revenue, lost at the High Court, but won at the Court of Appeal; the advancement was effective.

So, the Inland Revenue was the one arguing in favour of the 'rule in Hastings-Bass' in the case which started this, not the beneficiaries; and it lost.

Wrong turn ahead

One of the claims made by the Inland Revenue was that the trustees must have a proper understanding of all the results of their actions in exercising a power of advancement for that power to be validly exercised.

As Lloyd LJ points out, this was explicitly rejected by the Court of Appeal in *Hastings-Bass*.

Unfortunately, less attention was paid to the following paragraph, which said that where a trustee exercised a discretion given by the trust, the court should not intervene, even if the full intended effect had not been achieved, unless:

> '(1) what he has achieved is unauthorised by the power conferred upon him, or (2) it is clear that he would not have acted as he did (a) had he not taken into account considerations which he should not have taken into account, or (b) had he not failed to take into account considerations which he ought to have taken into account.'

Turn around when possible

Lloyd LJ's analysis highlights a confusion in the cases over whether the rule renders the transaction void or voidable.

The original *Hastings-Bass* case could only be won by the Inland Revenue if the creation of William's life interest was entirely void, since William was hardly going to ask for it to be annulled if it were only voidable.

Its argument was therefore that the trustees had no power at all to do what they did, namely to create a settlement which breached the rule against perpetuities.

It lost because the offending parts of the settlement (the trusts for William's children) could be separated from the valid ones (the life interest for him), without leaving a transaction that could not be seen as beneficial for the person to whom the advancement was being made.

Since William obtained a life interest where he previously only had a reversionary interest, this latter test was clearly met.

Trustees acting within powers but breaching duty of care

In *Green v Cobha*m, the trustees acted within their powers, but breached of their duty of care in exercising them.

Cross LJ said that this makes the transaction voidable, rather than void. It is subject to the court's discretion, and to equitable defences.

The trustees' duty of care does not require them to be completely correct in everything they do.

Futter v Futter

This was a typical case of the *Green v Cobham* type. The trustees had enlarged an existing life interest in an overseas settlement into an absolute interest, on the assumption that this would allow stockpiled gains in the trust to be offset by losses incurred by the beneficiary.

Although advice had been given by a leading firm of solicitors on this point, that advice was wrong; the offset is prohibited by TCGA 1992, s 2(4) [4]. The High Court had set the enlargement aside under the rule as previously understood.

In Cross LJ's analysis, the enlargement was within the power of the trustees and, it appears, was for the benefit of the life tenant, since he became absolutely entitled, so it was not void.

Since proper advice had been taken the duty of care had not been breached, and the transaction was not voidable.

Pitt v Holt

Mr Pitt had been in a road traffic accident in 1990 and had suffered serious injuries, including a mental disorder which left him unable to manage his own affairs. He was granted damages in a structured settlement amounting to £1.2 million, some of which was to be paid in a lump sum and some by regular monthly payments.

Mrs Pitt, acting as his receiver and after taking advice, asked the Court of Protection for permission to transfer some of the capital and the right to the monthly payments into a discretionary trust, and that permission was granted.

The trust had been set up to save income tax but unfortunately, the inheritance tax consequences of the trust had not been considered, and the trust did not fall within the exemption provided by IHTA 1984, s 89 [5], though a small change to its terms would have enabled it to.

As a result, there was an immediate liability of around £100,000 on the £800,000 of value transferred, with a further liability to exit and ten year charges.

Mrs Pitt's power to enter into the deeds of settlement could not be challenged, since it had been approved by the Court of Protection. They were not the result of a breach of her duty of care, since she had taken and followed (incorrect) legal advice. HMRC therefore won their appeal.

The future

It will no longer be possible to correct disadvantageous decisions by trustees. Most trustees who take advice will be held to their decisions, with their only recourse being an action against the advisers.

Even where no advice was taken on the specific issue, this is unlikely to help; the IHT position was never considered by the advisers in *Pitt v Holt*, but the judge held that among her various advisers one of them must have been under a duty to consider the capital tax consequences.

In a more typical private trust case, where the actions taken by the trustees were undertaken purely for tax planning and no other benefit accrued, it might still be possible to claim that the transaction was outside the trustees' power if the tax consequences turned out to be detrimental and there was no other benefit that could be pointed to.

From an article by Mike Truman writing in Taxation

Trust management expenses (*Lecture P660 – 8.40 minutes*)

Following the Court of Appeal's decision in CRC v Trustees of Peter Clay Discretionary Trust – Court of Appeal 2/1/09, HMRC recently published revised guidance (in April 2011) on trust management expenses. See Trusts, Settlements and Estates Manual paras TSEM8000 to TSEM8790.

Background

In the Peter Clay case the trustees claimed that expenses relating to management of the trust were to be treated as income expenses for the purposes of Section 686(2AA) TA1988 – now Section 484 ITA2007. The Special Commissioners said that a fair balance should be reached between income and capital, but on 15 November 2007 the High Court held that within the general law of trusts the expenses of the trustees should be regarded as a capital expense and the Commissioners had erred in law when saying that they should be apportioned.

Court of Appeal

The Court of Appeal held that the expenses should be looked at as between 5 categories:

1. trustees' fees
2. investment management fees
3. bank charges
4. custodian fees
5. professional fees for accountancy and administration

It determined that the Commissioner's decision to allow all the expenses except for investment management fees was indeed incorrect, and that expenses incurred for the benefit of both the income beneficiaries and the capital beneficiaries should be charged against capital under general law. It was only expenses incurred exclusively for the benefit of the income beneficiaries that could be charged to income, and in that respect if fees for accountancy services could properly be apportioned on a time basis between fees attributable to dealing with the income of the trust fund and the capital, "it was impossible to see why the fees charged by the executive trustee for time spent in applying his professional judgement to the matters in relation to which those accountancy services were required should not also be capable of a proper apportionment".

HMRC new guidance

They seemingly are taking a common sense approach to the apportionment of expenses, with the main points from paras TESM8000 to TESM8790 being as follows:

When considering whether they should charge an expense to capital or income the trustees look in order to:

- any Court Order relating to the Trust
- the trust deed
- any relevant trust statute
- general trust law

For tax purposes as well, where there is a Court Order that specifies how an expenses should be charged or there is a specific statute, the terms of either of them take priority.

The provisions of the trust deed, and general trust law, have varying effects for tax purposes which depend on the type of trust.

For a discretionary trust, what expenses are properly chargeable to income is determined by giving priority to general trust law.

For an interest in possession trust priority is given to the trust deed.

To apportion an expense the trustees can refer to the time records maintained by person charging the costs. If there are no time records there may be other documentation which assists, and in this connection the costs can be apportioned to reflect the volume and complexity of the trust accounts.

Failing that para TSEM8168 says that a realistic estimate may be taken of the costs related to income as part of the fees payable to trustees.

No deduction is claimable within a bare trust as the income used to pay the expenses is income that belongs to the beneficiary.

No deduction is claimable where the trust is a settlor-interested trust as the gross income is the income arising.

Contributed by Gerry Hart

Administration

New task forces to tackle tax dodgers

HMRC will use specialist teams to undertake intensive bursts of compliance activity in high risk trade sectors and locations; the first will focus on the restaurant trade, targeting businesses in London over the coming weeks.

New task forces to tackle tax dodgers were announced today by HMRC.

The first task force will focus on the restaurant trade, targeting businesses in London over the coming weeks.

The specialist teams will undertake intensive bursts of compliance activity in specific high risk trade sectors and locations across the UK. The restaurant trade in Scotland and the North West will be the next areas targeted.

They come as a result of the Government's £900m spending review investment to tackle tax evasion, avoidance and fraud from 2011/12, which aims to raise an additional £7bn each year by 2014/15.

Mike Eland, Director General Enforcement and Compliance, said:

> “These task forces are a new approach which uses HMRC's resources to identify and tackle rule-breakers and evaders swiftly and effectively.
>
> “Only those who choose to break the rules, or deliberately evade the tax they should be paying, will be targeted. Honest businesses have absolutely nothing to worry about.
>
> “But the message is clear - if you deliberately seek to evade tax HMRC can and will track you down, and you'll face not only a heavy fine, but possibly a criminal prosecution as well.”

HMRC is planning a further nine task forces in 2011/12, with more to follow in 2012/13.

HMRC press release 12 May 2011

13 years’ of assessments

The taxpayer appealed against a number of HMRC assessments made under TMA 1970, s 29 for the tax years 1990/91 to 2002/03, and 2003/04 and 2004/05.

The taxpayer had been a self-employed landscape gardener for several years. It was not until 2009, when statements for a bank account in his name came to light during an enquiry into the tax position of a third party, that he came to HMRC’s attention.

This caused the department to carry out an investigation into the appellant in respect of the earlier years which would go back beyond the normal time limit.

They issued 13 years’ worth of assessments made to the best of the officer’s judgment, as little could be ascertained about the taxpayer’s lifestyle.

The taxpayer appealed.

The First-tier Tribunal agreed with HMRC that the officer had ‘discovered’ that the appellant had income which ought to have been assessed to tax for 13 earlier years.

The issue then was whether the taxpayer had deliberately not informed the Revenue about his taxable earnings. The tribunal found that, as referred under TMA 1970, s 36(1A), ‘Failure is sufficient, whether or not it is deliberate.’

With regard to the estimates used in the assessments, the tribunal confirmed HMRC’s figures saying the taxpayer had not shown that the amounts used were excessive.

Mr Stanley’s appeal was dismissed.

D Stanley (TC1038)

Asking for help

The taxpayer tried to file her tax return online in January 2010 but found that she could not access the website. She contacted HMRC's support line but did not receive a reply.

She eventually submitted a paper return in December 2010. HMRC issued two late filing penalties: one for not filing by 31 January and the second for still not having filed her return six months later.

HMRC claimed the taxpayer had emailed the VAT online services helpdesk in error, and the department argued it was the taxpayer's responsibility to ensure her tax affairs were dealt with correctly and on time.

It said the responsibility was not negated by her having sent two emails to the helpdesk. HMRC argued further that they could not reasonably be expected to reply to her emails before 31 January 2010.

The First-tier Tribunal judge said he found the latter proposition 'startling'. He was sure HMRC would expect a business to which they had sent correspondence not only to be able to reply within 14 days but actually to do so.

He said, 'There is no reason why the standards applicable to businesses and commercial organisations should not also apply to an organ of the state.'

The judge agreed it was the taxpayer's responsibility to file her self assessment return on time, but 'it was equally the responsibility of HMRC to provide online filing facilities that worked and provided the promised filing facility'.

He was 'wholly unimpressed by the argument that there was no obligation on HMRC to reply to the appellant's emails to its helpdesk; there is little point in there being a helpdesk if, in fact, it does not provide help.'

The taxpayer was entitled to have expected that the requested help would arrive in time for her to be able to use the online filing facility by 31 January 2010. She therefore had a reasonable excuse for failing to file online by the 31 January 2010.

The excuse was that the online filing facility provided by HMRC did not work as it should have and, furthermore, HMRC failed to provide her with the help she had requested within a reasonable time, which, the judge suggested, should have been within three days. The first penalty was not therefore due.

With regard to the second £100 penalty, the judge said the same excuse could not possibly apply to the continued failure to file. The appellant should, in the circumstances, have taken steps to submit her return sooner than she finally did.

The taxpayer's appeal against the first penalty was allowed, but her appeal against the second was disallowed.

Louise Fernandez (TC1123)

Online filing for year-end returns

For the tax year ended 5 April 2007, the taxpayer company's form P35 was filed by its accountants using an online facility.

The company was not registered to do its own online filing, and it was not mandatory for the firm to file online.

However, HMRC argued that because the 2006/07 form P35 was filed online, the department was entitled to assume the company would file future years' end-of-year forms online, and so paper forms were not sent to the appellant.

The company did not submit a 2007/08 form P35 on the grounds it could not return a form that it had not been sent.

HMRC issued a late filing penalty for the period 20 May to 19 September, and a further penalty for the period 20 September to 5 December. The company appealed, claiming reasonable excuse.

The First-tier Tribunal judge said HMRC had to satisfy him that the company had elected, by word or deed, not to receive a paper P35 return and that the department was justified in failing to provide a necessary paper return.

He said HMRC had failed to produce evidence to that effect, and he noted HMRC had 'assumed' there was no need for them to issue a paper return, even though the paper form would have pointed out to the company that it had to be submitted by 19 May 2008.

Noting that this was a period when online filing for P35s was not compulsory, the judge decided the company had a reasonable excuse throughout the entire default period, given that HMRC accepted they had failed to send a paper return.

The judge added that even if the first penalty had stood, the second penalty could not, because HMRC, knowing the P35 had not been filed on time, did not send the first penalty notice to the company until 29 August 2008, 19 days after the start of the period in which a second penalty could be levied.

The judge said this was 'not plain dealing'. As a matter of common fairness and justice, HMRC should give the defaulting party a chance to remedy the default.

The taxpayer's appeal was allowed.

N A Dudley Electrical Contractors Ltd (TC1124)

Failure to pay NIC due to neglect of directors

Facts

Innova was a staff agency company that provided personnel with specialist qualifications to businesses in the financial services industry such as banks, insurance companies and others on short term contracts. It was the successor company of Synergi Global Solutions Ltd, a company in which both Appellants were directors. It carried on a similar business to Innova but went into liquidation by order dated 27 July 2007 with PAYE tax and NIC owing of £103,733.07

Innova kept payroll records showing that PAYE tax and NIC had been regularly deducted from the wages of its employees.

The Appellants were aware that Innova had a statutory obligation to pay PAYE tax and NIC to HMRC each month. Innovas accountant was responsible for sending PAYE tax and NIC to HMRC on the instructions of a director. The Appellants were the sole signatories on Innovas bank account.

No such instructions were ever given, as no NIC or PAYE tax was ever remitted by Innova to HMRC.

Each month, from the outset of Innovas trading, the Appellants conducted a financial review and each month they took the decision to refrain from making any payments of PAYE tax or NIC, preferring to pay their own substantial salaries and other creditors. Mr Martins salary was £75,000 per year and Mr Roberts was £125,000 per annum.

The Appellants were, in effect, propping up Innova with funds which ought to have been remitted to HMRC. Innova did not at any stage generate enough funds to pay its debts as they fell due. The Appellants were aware of this.

Shortly before Innova went into liquidation, certain contractors were paid to ensure that their services could be used by a planned successor company (Cornerstone Resources Ltd). In particular, between March and April 2008, trade creditors were reduced from £104,025.21 as at 17 March 2008 to £24,119.51 as at 2 April 2008. However, no payments were made to HMRC.

On or about 4 November 2009, a PLN was issued to each Appellant. The total sum claimed was £90,959 apportioned equally between each Appellant. The total sum was made to best judgment as there were gaps in the records of Innova. However, there is no challenge to the validity of the notice, quantum or the apportionment.

On 22 February 2010, the Appellants requested an internal review. On 19 March 2010, the review officer concluded that the decision to issue the PLNs was justified. On 15 April 2010, the Appellants appealed to this Tribunal.

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Issues

The issue was whether the failure by Innova to pay NICs, was attributable to neglect on the part of the Appellants. HMRC apportioned liability equally to each Appellant. That apportionment (if liability were to be established) was not disputed by the Appellants. Quantum was also not in dispute.

The directors believed that:

(i) they did not act negligently; the non-payment of PAYE Tax and NIC was a result of adverse business conditions,

(ii) they were prudent in that they *inter alia* held monthly meetings and allocated funds to business critical activities,

(iii) they never planned not to pay HMRC what was due, and

(iv) the economic business climate ensured that they were, in effect, not in a position to pay.

Decision

Neglect consists of a failure to do what, in the circumstances, a reasonable and prudent person would have done. Neither party disputed that proposition.

The Appellants were fully aware of the statutory obligations in relation to payment of NIC.

They received information each month about the financial health of Innova including the amount of NIC due and payable by the 19th of the month. They were personally responsible for ensuring the payment of NIC and PAYE tax. They were responsible for the decision each month, while Innova traded, not to pay NIC and PAYE tax and chose instead to pay other creditors and their own salaries; they thus propped up for as long as possible an ailing business with funds which should have been remitted to HMRC. No attempt was made to discuss matters with HMRC.

Individuals such as the Appellants should not be allowed to shelter behind the shield of limited liability of companies which they use to trade in order to pay themselves large salaries at the expense of ordinary business creditors who follow ordinary standards of business decency, and the general taxpayer, who suffers a double loss.

The appeal was dismissed.

TC01130: Stephen Roberts & Alan Martin

RELEASE DATE: 26 APRIL 2011

Business Taxes

Were property losses those of a trade?

Introduction

In 2006/07 and 2007/08 the Appellant's tax return showed losses from property rental deducted against general income. Until the 2006/07 tax year, the income from the properties was always returned as letting income but then the Appellant changed tax advisors.

Following an enquiry, HMRC concluded that the Appellant's activities giving rise to the claimed losses "amount to a UK property rental source and not an adventure in the nature of trade as a property dealer/developer".

The appellant appealed.

Appellant's case

Her intention from the outset was to buy property and sell it for a profit. She bought the properties at a high price, and then the financial crisis came and the market deteriorated. Thinking that this would not last long, she bought more properties.

She purchased her first property in 2002. She purchased at a higher price than she should have because she was too eager to get started. She did not think that the Newcastle residential property market was in difficulty in 2002 when she purchased the first property, but that the difficulties came in the next 2 to 3 years, in about 2004/05. By then she had three or four properties. She had anticipated that she would keep the properties for about six months before selling them. She bought the last property in 2006 because the price was very low.

When asked how long the period was between buying the first property and getting students in, she said that this happened very quickly, perhaps within 4 to 6 weeks, after basic repairs and maintenance, as she needed the rental income to service the debts. She has had students in all of the properties. A member of her family collects the rents and does maintenance.

When asked what her involvement is in the properties, she said that she pays the mortgages, and deals with problems with the students, when rent has not been paid or to arrange with her handyperson for repairs to be done. She also deals with an agency to get more tenants, who are generally foreign students.

When asked whether in 2002 she had had previous experience buying and selling property, she said that when she was in her teens her parents bought and sold property and dealt with students. She said that she went on seminars and courses, such as on how to bid at an auction. She said that while she made a mistake at the beginning by buying property at too high a price, she had learned from her mistake.

Badges of trade

The tribunal considered the Badges of Trade:

(a) None of the properties have yet been sold by the Appellant. There has therefore been no sale transaction, one-off or otherwise. However, some eleven properties have been bought, so that the purchase transactions are not merely one-off.

(b) Each of the transactions for purchase of property may be considered related to each of the other transactions for purchase of property, but these transactions are unrelated to the trade which the Appellant otherwise carries on, which is a beauty salon.

(c) Real estate is a commodity of a kind which can be the subject matter of trade, but which is at least equally commonly the subject-matter of investment. It is not a commodity which can only be turned to advantage by realisation, since it can also generate rental income, or a capital gain on an investment.

(d) As no property has yet been sold, it cannot be said that any transaction has yet been carried through in a way typical of the trade in a commodity of that nature. The purchase of properties, followed by tenanting for several years, is not typical of a trade in real estate.

(e) The Appellant has argued that the properties have been financed by means that would make sense only if the Appellant intended to turn the properties over quickly. The Tribunal does not have sufficient details of the financing of the properties to enable it to determine whether it accepts that this is the case. The Tribunal does however accept that the Appellant's activities in relation to the properties are generating a loss, and accepts that losses cannot continue to be sustained indefinitely.

(f) There is no evidence that the Appellant has undertaken significant improvements to the properties. On the evidence, the Tribunal finds that there is no evidence of works beyond repairs that would be normal for rental properties.

(g) There is no evidence that the Appellant has intended to resell the properties otherwise than in the same lots in which they were bought. There is no evidence for instance, of an intention to sub-divide properties or to convert houses into flats.

(h) The Appellant's intention at the time that she purchased the properties was the major issue in contention between the parties. The Appellant's evidence is that in relation to each of the properties, her intention at the time of purchase was to resell the property for a profit within a short timeframe of about six months. HMRC suggests that her intention from the beginning was to rent the properties out. This issue is considered further below.

(i) The properties did produce rental income pending any resale, although insufficient income to generate an overall profit from the activities as a whole.

The Tribunal found that on a balance of probability that at the latest by the time that she brought in the first students as tenants, several weeks after she bought the first properties, she realised that the properties would have to be rented out for a significant period before they could be sold. The Tribunal found on a balance of probability that by then at the latest it was her intention to keep the properties as rental properties for an undefined period, possibly with a longer term aim of selling them for a capital gain.

The Tribunal adds for completeness that it also does not exclude the possibility that it was from the beginning the intention of the Appellant to rent the properties, possibly with the longer term aim of selling them in order to realise a capital gain.

The Tribunal found that the nature of the Appellant's own activities in relation to the properties, as described by her in her evidence, is consistent with those of a landlord.

For the reasons given above, the Tribunal dismisses the appeal.

TC00928: Parveen Azam

Release date: 14 January 2011

Deductibility of counselling expenses

The case

Mrs Azam appealed against an amendment to her self-assessment return for 2002/03 by which her trading profits were increased by the adding back of £30,995. This sum represented the costs incurred principally on training or counselling sessions.

HMRC said that these expenses were not incurred exclusively for the purposes of her trade, and were therefore not deductible.

‘Exclusively’

In *Vodafone Cellular Ltd and others v Shaw (Inspector of Taxes)* 1997 STC 734, contained a helpful summary in the judgment of Millet LJ of the effect of the word "exclusively" in S74:

"The leading modern cases on the application of the exclusivity test are *Mallalieu v Drummond*...and *MacKinley (Inspector of Taxes) v Arthur Young McClelland Moores&* Co... From these cases the following propositions may be derived.

"(1) The words for the purposes of the trade mean to serve the purposes of the trade. They do not mean for the purposes of the taxpayer but for the purposes of the trade, which is a different concept. A fortiori they do not mean for the benefit of the taxpayer.

"(2) To ascertain whether the payment was made for the purposes of the taxpayer's trade it is necessary to discover his object in making the payment. Save in obvious cases which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of payment.

"(3) The object of the taxpayer in making the payment must be distinguished from the effect of the payment. A payment may be made exclusively for the purposes of the trade even if it also secures a private benefit. This will be the case if the securing of the private benefit was not the object of the payment but merely a consequential and incidental effect of the payment.

"(4) Although the taxpayer's subjective intentions are determinative, these are not limited to the conscious motives which were in his mind at the time of the payment. Some consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made.

"To these propositions I would add one more, The question does not involve an inquiry of the taxpayer whether he consciously intended to obtain a trade or personal advantage by the payment, The primary inquiry is to ascertain what was the particular object of the taxpayer in making the payment,. Once that is ascertained, its characterisation as trade or private purpose is in my opinion a matter for the [tribunal] not the taxpayer."

The Facts

Mrs Azam ran a beauty salon in Newcastle. She had four treatment rooms and employed two full time staff and three or four part time staff. In other years she had up to seven staff. Most of the staff were 18 to 20 year old girls.

She had difficulty dealing with issues such as those where she needed to confront her staff. She found help in dealing with these issues in counselling sessions she attended with Calcioli Field Practice.

Mrs Azam had studied Scientology for some time and had found it very helpful in her everyday life. Mrs Azam told us that Calcioli provided counselling on the principles of the Church of Scientology, that Calcioli had a licence from the Church of Scientology to deliver counselling using its principles in particular areas, and that it applied the principles set out by L Ron Hubbard in counselling her.

Mrs Azam accepted that she had derived personal benefits from the sessions. They had given her more confidence in everyday life. She applied the principles she had used in her business and derived from the sessions in dealing with people outside business life. She found it easier to stand her ground, she was more stable in her thinking, and was less likely to be diminished by others.

Mrs Azam had also been to counselling sessions in the earlier years of her business activity. thus in 2002/03 she knew what benefits she would receive as a result of them.

Findings

The Tribunal consodiered that by 2002/03 she knew that she obtained benefits from the counselling sessions which she felt enhanced her normal life, and that she sought this type of counselling knowing that it provided help in her everyday dealings and in how she felt about herself and because she was attached to the Scientology philosophy and found benefit from it.

They concluded that Mrs Azam had two purposes in mind when she attended these sessions. One was to help her deal effectively with difficulties which arose in her business. The other was to enhance her own wellbeing.

Accordingly the expenses were not incurred exclusively for the purposes of Mrs Azam's business, and were not deductible from its profits.

Appeal dismissed

TC00895: Parveen Azam

Release date: 20 December 2010

Was sponsorship expenditure "wholly and exclusively" for the trade?

The Appellant Company, Protec International Limited, trades in supplies to the construction industry.

From 2002 to 2005, ‘sponsorship’ payments were made to McKinstry Motorsport.

The sole director and shareholder of the Appellant Company is Mr James Harrison who had a longstanding and significant involvement in rallying.

Findings

The Appellant company paid McKinstry Motor Sports as sponsorship/advertising fees:

(a) During 2002, £70,000 net of VAT

(b) During 2003, £70,000 net of VAT

(c) During 2004, £125,000 net of VAT

(d) During 2005, £125,000 net of VAT

There was no written form of contract specifying full particulars of what was expected for the sponsorship. The invoice of McKinstry Motor Sports to the Appellant dated 28 December 2004 and an undated letter enclosing payment to McKinstry Motor Sports from the Appellant Company use the phrase "as discussed" in reference to the sponsorship arrangement between the parties.

No formal review of the benefits of the substantive expenditure incurred has ever taken place.

Requests for information from HMRC in respect of the sponsorship and any connection or benefit of Mr Harrison personally or his family from McKinstry Motor Sports was responded to in a piecemeal manner.

There were delays in responding to requests for information leading to the issue of notices on the 17th of February and 16th of November 2006 which were not complied with resulting in the imposition of £50 penalties and subsequent daily penalties.

Misleading statements/assertions were made during the enquiry to HMRC namely:

(a) In a letter by the company's accountants of 9th October 2007 it was stated that Mr Harrison had no involvement in rallies since 2005. When this was challenged by HMRC it was accepted this was incorrect.

(b) In a letter dated 4th September 2006 the Appellant's Accountant stated that Mr Harrison's involvement in rallying was "low key." The documentation evidence in the hearing bundle demonstrates a substantial involvement of Mr Harrison in motor rallying. The rally reports demonstrate Mr Harrison competing regularly at a high level, winning the Dunlop National Championship in 2003 and a number of individual rallying events.

(c) In a letter dated 5th October 2009 the Appellant Company's Accountant stated "Mr Harrison does not drive the vehicle being sponsored nor any of McKinstrys vehicles". The rally reports in the hearing bundle together with the statements/assertions made by the Appellant's representative at the hearing demonstrate that Mr Harrison had regularly driven rally cars belonging to McKinstry Motor Sports. The letter of 5th October 2009 refers to "the vehicle" whereas the assertions made at the hearing (uncorroborated by primary evidence) referred to 12 motor vehicles being the subject of the sponsorship.

The amount of sponsorship paid to McKinstry Motor Sport was substantial in comparison with the advertising expenditure incurred by the Appellant Company.

The assertion made by the Appellant's Accountants that there had been a 76% increase in turnover as a result of the sponsorship of McKinstry Motor Sports had not been corroborated by any detailed analysis as to the number of leads generated as a result of sponsorship as against the other forms of advertising.

Mr Harrison was not called to give any evidence in support of the appeal, the onus of proof being on the Appellant. The Tribunal considered the Appellant's objective in making the payment but found that without any direct evidence at all from Mr Harrison it could not be satisfied as to his subjective intentions on behalf of the Appellant Company at the time of entering into the Agreements. Given the distinct lack of evidence from the Appellant/Mr Harrison, either orally, in writing or documentary, the Tribunal found there were no satisfactory answers to the questions which had been posed by HMRC throughout the duration of the enquiry.

In particular why Mr Harrison decided to sponsor McKinstry vehicles in particular, the nature of their relationship, whether any alternatives had been considered, the nature of the business agreement between the parties particularly bearing in mind the lack of any formal contract or business plan and how the sponsorship was intended to bring the name of the business or its products before the intended target audience.

The Tribunal found the demonstrable lack of formal commerciality in the transaction inferred non-trade purpose. Taken together with the apparent lack of any type of review of the effect on the trade of the sponsorship, contradictory and misleading assertions and absence of any evidence from Mr Harrison, the Tribunal could only reach the inevitable conclusion that the Appellant Company had been deliberately evasive in order to hide the benefit Mr Harrison received from the sponsorship and therefore there was a duality of purpose in the expenditure. The Tribunal found that the onus of proof had not been discharged by the Appellant.

The appeal is dismissed.

TC00867: Protec International Limited

Release date: 2 December 2010

Points for discussion

Is there an argument for taxing Mr Harrison on a benefit in kind in respect of the sponsorship? It would appear that he does receive a substantial benefit from the company payments. If this was a taxable benefit would the sponsorship costs then be allowable as part of the owners remuneration package – subject to meeting any "reasonable level" arguments HMRC may raise?

Income recognition and negligent conduct

Background

The First Tier Tribunal decided that the way in which Mr Smith's accountants had prepared his accounts for each of those years was in two respects not in accordance with generally accepted accounting practice at the relevant time, and that this constituted "negligent conduct" by a person acting on Mr Smith's behalf which resulted in a tax loss that HMRC had "discovered".

Mr Smith appealed against the Tribunal's decision in relation to the date at which income was recognised in his accounts.

The facts

Mr Smith traded as sole trader. His accounting period was the same as the tax year i.e. 6 April to 5 April. He carried on business as a subcontractor undertaking ground works for construction companies. The contracts were generally fixed price contracts for carrying out works over a period of between a month and a year. The typical length of contract was two to three months. He had a number of employees.

At the end of the contract, or sometimes at intervals during the contract, Mr Smith would make an application for payment to the main contractor. The application for payment would be based on an assessment made by a quantity surveyor employed by Mr Smith. Within a week or so of the application for payment, the contractor's quantity surveyor would visit the site and inspect the work. The contractor would then issue a valuation certificate based on its quantity surveyor's assessment. Payment would generally be made by the contractor some 30 days after the application for payment and about two weeks after the issue of the valuation certificate. It is common ground that no debt was due and owing to Mr Smith until the valuation certificate was issued. Importantly, however, the

Tribunal found that "the sums requested in applications for payment were generally paid in full or in amounts which varied by only a few percent from the amounts claimed".

From 1997 onwards Mr Smith employed Maynard Heady to prepare his annual accounts and tax returns. Gary Tidbury FCA was the partner responsible. In preparing Mr Smith's accounts, Mr Tidbury took the view that income could not be recognised when the application for payment was made, but only when the valuation certificate was issued.

The issue

The issue on this appeal is whether income should be recognised when the application for payment was made or when the valuation certificate was issued.

Mr Smith appealed on three main grounds.

1. No reasonable tribunal properly directed as to the law could have concluded from the evidence that the only correct point at which to recognise income was when the application for payment was made rather than when the valuation certificate was issued. Instead, the only conclusion which the Tribunal was entitled to reach was that both methods were acceptable methods of commercial accounting at the relevant dates.
2. The Tribunal exceeded its jurisdiction in making a finding of professional negligence on the part of Mr Tidbury, or at least applied the wrong test for "negligent conduct".
3. The Tribunal was wrong to conclude that HMRC had "discovered" a tax loss in relation to the years 1997/98 to 1999/2000 and 2001/2002 since it made no findings of fact which could support such a conclusion, or at least which supported its conclusion in relation to the three earlier years.

Findings

The First Tier Tribunal had based their decision on accounting standards in force at the time, namely SSAP 2 and FRS 5

Both methods (recognising income when the application for payment was made and when the valuation certificate was issued) were supported by expert professional opinion and it was common practice to adopt the latter approach in construction industry accounts at the time. However, the Tribunal had noted that Mr Tidbury's own evidence was that "Mr Smith was unusual in that he used his own quantity surveyor to trigger his application for payment [whereas] other businesses [i.e. other businesses in the construction industry] had less good records and procedures and simply sent unquantified requests for payment". Accordingly, as the Tribunal said at paragraph 78:

"… even if the method was used for other construction Companies, and even if its use for them was generally accepted accounting practice, we do not see why that meant that it should apply in Mr Smith's circumstances."

As counsel for HMRC submitted - Mr Smith's good records and procedures meant that he was in a position to recognise income, and match it to expenditure, earlier than less well-organised businesses.

No negligent conduct

Counsel for Mr Smith argued that the Tribunal only had jurisdiction to consider whether there was "negligent conduct" by a person acting on behalf of a taxpayer. It did not have jurisdiction to consider whether an accountant was guilty of professional negligence, which was a matter within the jurisdictions of the ordinary civil courts and the professional regulatory body, namely the ICAEW.

However, the Tribunal did not actually find that Mr Tidbury was guilty of professional negligence. It found that that he was guilty of "negligent conduct" applying the standard of professional negligence to determine whether there had been a breach of duty.

Ss29 and 36 TMA 1970 explicitly require the relevant tribunal to consider whether there has been "negligent conduct" by a person acting on behalf of a taxpayer. The person who is most likely to have been acting behalf of the taxpayer in such circumstances is his accountant or tax advisor. I find it difficult to see how the Tribunal can have exceeded its jurisdiction by making a determination which the statute requires it to make.

Wrong test

Counsel for Mr Smith submitted that the standard by reference to which the Tribunal had judged Mr Tidbury's conduct was that of a normally competent accountant and tax advisor, whereas the standard it ought to have adopted was that of the reasonable lay person.

This was held not to be the case. Where the person acting on behalf of the taxpayer is an accountant engaged by the taxpayer to prepare his accounts, I agree with the Tribunal that the accountant's conduct should be judged by reference to the standard of the ordinarily competent accountant.

No discovery

Mr Smith's third ground of appeal was that the Tribunal made no findings of fact which supported its conclusion that HMRC had discovered a tax loss in relation to the four tax years that matter, or at least in relation to the three earliest years.

However, the Tribunal's decision was crystal clear as to who made the discovery, namely Mr Cotton acting for HMRC, and in relation to which years of account. The Tribunal's decision is also clear as to what Mr Cotton discovered, namely that in preparing Mr Smith's accounts Mr Tidbury had not recognised as income sums which at the year-end had been the subject of an application for payment, but not a valuation certificate, thereby understating Mr Smith's revenue and profits during that year.

Conclusion

The appeal is dismissed.

Smith v Her Majesty's Revenue and Customs, Upper Tribunal

Release date: 10 May 2011

Dilapidations: Correct Tax Treatment (Lecture B657 – 10.11 minutes)

As readers will be aware, the capital/revenue split of expenditure on buildings is a common area of enquiry by HMRC. Such enquiries will often examine the treatment of expenditure when businesses are vacating properties, in particular that relating to ‘dilapidation provisions’ in leases.

Dilapidations are works of repair or re-instatement for which a lessee is liable, if the lease provides that the lessee is responsible both for repairs and for delivering up the leased property at the end of the lease in the state in which it was at the beginning of the lease.

Is expenditure on dilapidations always allowable?

Many businesses operate under the misconception that any amounts expended as a result of a dilapidation provision in a lease are allowable for tax (on the basis that they have been incurred wholly and exclusively for the purposes of the trade), but this is not the case. Some expenditure on dilapidations may be of a capital nature and as such is inadmissible as a deduction.

HMRC’s Business Income Manual, at BIM43255, gives examples of such capital payments, including:

- the cost of rebuilding the leased premises (see Fitzgerald v CIR [1926] IR 585), or
- the cost of re-instatement of any portion of the leased premises which has been demolished by the lessee, or
- the cost of the demolition of any structure which the lessee has added.

The latter would include, for example, the demolition of partition walls that the tenant has previously installed.

In contrast, payments under a dilapidation provision will be allowable to the extent they relate to *deferred repairs*, where that cost would have been allowable for the trader if the repairs had been carried out during the currency of the lease (BIM43260). This would clearly cover work to put right normal wear and tear, including redecoration.

Composition payments

Out there in the real world, the tenant does not always take responsibility for doing the repairs directly. More commonly, the tenant makes a cash payment to the landlord in lieu of having to do the repairs; the landlord then carries out the repairs, often once the tenant has left.

Such a payment by the tenant is known as a 'composition payment'. This is also allowable to the extent it covers deferred repairs (as opposed to work of a capital nature). Note that, to be allowable for the tenant, there is no requirement for the landlord to actually do the repairs: it is sufficient that the payment relates to deferred repairs.

A sum paid to the lessor, by way of composition, to make good the cost of dilapidations is an ***inadmissible*** deduction where such cost is incurred:

- by the former tenant on renewal of the lease (as on the principle in MacTaggart v Strump [1925] 10TC17, it will be treated as a lease premium) or
- where it is incurred by a new tenant to whom a lease of the premises has been granted in their dilapidated state.

Timing of deductions

If a tenant has made a provision for future dilapidations, then there is an opportunity to claim deductions for tax purposes when the provision is made. This is because the provision itself is made in anticipation of future expenditure on the repair of the premises.

If the tenant meets the following criteria, as outlined under UK GAAP (FRS 12) or IFRS (IAS 37), then the provision will be a specific provision.

- The entity must have a present obligation as a result of a past event (which is most likely to be a contractual obligation in the lease contract and is almost always present).
- It must be probable that a transfer of economic benefits will be required to settle the obligations (i.e. there is greater than 50% probability that the landlord will demand the work be done).
- A reliable estimate must be made of the amount of the obligation. (Accounting standards assume that this will always be possible.)

The property in question must also be used for business purposes and the lessee must be responsible for repairs to the property and have an obligation to deliver the property in the state in which it was at the beginning of the lease.

If these conditions are met, the tenant may be eligible to take tax deductions for the dilapidations provision (as long as the work is not of a capital nature, as discussed above). The proportion of any **specific** provision that relates to works that are capital in nature will not be deductible for tax purposes (s53 CTA09). However, a full deduction can be taken for the remainder of such a provision.

In contrast, no tax deduction is allowed for a general provision.

Timing and Adjustments

If a specific dilapidations provision has been made, the amount that is assigned to the revenue works is tax deductible as and when the provision is taken.

A provision will be deductible provided that:

- the profit would not be adequately stated if the obligation was not taken into account; and
- a provision is made within the accounts; and
- a sufficiently reliable figure has been adopted.

At the end of the lease, when the final works are carried out and the actual cost for these works is known, it is likely that an adjustment will need to be made. If the provision was in excess of the actual expenditure, then the difference is added back to the taxable income and taxed in the year of the works. If there is an under provision, then the excess actual expenditure is allowable for tax as a deduction within the year.

If no dilapidations provision has been made (because the conditions set out in FRS 12/IAS 37 are not met), then relief for the expenditure will be given when the actual expenditure is incurred. This should be extremely rare in practice.

Costs incurred by a tenant in improving a leased property

Finally if, as part of the lease, the tenant agrees to restore the property to a good state of repair (i.e. better than at the outset of the lease), the repairs are capital expenditure (Jackson v Laskers Home Furnishers Ltd. [1956] 37TC69). In some circumstances the tenant may be able to get some tax deduction under the lease premium rules.

Contributed by Kevin Read

Partnerships buying software

Two partnerships were set up to acquire rights in elements of a software package and to exploit them. The investors only put up 25% of the money themselves, the other 75% was provided by non-recourse finance.

In economic terms, only the money put up by the investors was used to finance the software development, the rest of the money was used to provide an indirect security for the repayment of the borrowing.

The Supreme Court upheld in part the original decision of the Special Commissioner that only the 25% of the funds provided by the investors had actually been expended on purchasing the software.

The judges looked at the principles of both *Barclays Mercantile Business Finance* [2005] STC 1, and *Ensign Tankers* [1992] STC 226, holding that both were still valid law. A full report will appear in a later issue of *Taxation*.

Jason Collins of McGrigors, solicitors for the taxpayer, said HMRC are likely to be emboldened by this ruling and use it to attack any form of tax planning.

The government may look again at a broad-based principled approach to tax legislation in the future, but this will give taxpayers far less certainty.

Tower MCashback LLP and another v CRC, Supreme Court

Associated companies (*Lecture B658 – 15.42 minutes*)

Where a company is associated with other companies, the corporation tax thresholds (ie. the upper and lower profit limits) are reduced accordingly. Broadly, the effect is to adjust the rate of tax to take account of the total profits of all associated companies, thereby ensuring that each associated company's tax rate is, in the words of HMRC, 'reflective of being part of a wider economic unit'. The test of whether companies are associated can be found in the rules governing 'control' as set out in S450 CTA 2010.

Many aspects of this regime are unexceptionable. Where companies are part of a group or are controlled by the same person (or persons), they are associated for the purposes of accessing the small profits rate. However, some facets of the legislation work in an automatic or mechanical way which serves to associate companies controlled by separate individuals, regardless of their wider circumstances. For example, the rules governing the attribution to an individual of rights held by another person linked to them can sometimes be unfair (eg. where a husband and wife each own a company and neither of the companies has any business involvement with the other). The Government's aim is to reform the existing rules by providing a test which retains the satisfactory aspects of the current legislation within a new test which attributes rights held by linked persons only in circumstances where the relationship between the companies makes it appropriate to do so.

This has been achieved by amending the wording in S27 CTA 2010 so that two companies will only be linked if there is 'substantial commercial interdependence' between them (Cl 55 F(No3)B 2011). 'Substantial commercial interdependence' is a term which was first used in ESC C9 and is defined in a Treasury Order entitled 'The Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Order 2011'.

Factors to consider

The following factors will be taken into account in determining whether or not there is a link between two companies:

- the degree to which the companies are financially interdependent;
- the degree to which the companies are economically interdependent; or
- the degree to which the companies are organisationally interdependent.

Financial interdependence

Two companies are financially interdependent if:

- one gives financial support (directly or indirectly) to the other; or
- each has a financial interest in the affairs of the same business.

Economical interdependence

Two companies are economically interdependent if:

- the companies seek to realise the same economic objective;
- the activities of one benefit the other; or
- the companies have common customers.

Organisational interdependence

Two companies are organisationally interdependent if the businesses of the companies have or use:

- common management;
- common employees;
- common premises; or
- common equipment.

HMRC have provided a detailed explanation of these expressions, along with a number of case studies, in their document entitled 'Companies With Small Profits: Associated Companies', which was published on 31 March 2011. In due course, this briefing will appear as part of the Company Taxation Manual.

The amendment discussed above has effect for accounting periods ended on or after 1 April 2011, but take note of Cl 55(3) F(No3)B 2011 which allows a company to elect for the new rules to apply only for accounting periods which begin on or after 1 April 2011. This election must be made within one year from the end of the accounting period to which it relates.

The majority of companies affected by the change will benefit from the revised regime. However, since it prima facie applies to accounting periods ended on or after 1 April 2011, it is possible that a small number of companies may be disadvantaged by the change. These are likely to be companies separately controlled by persons who are also partners in another business. For such companies, there will be a drawback if they are associated by the new rules but would not have been caught by the previous version of S27 CTA 2010.

Illustration 1

McDowell and McIlroy are partners in a law firm.

In addition, McDowell owns 100% of the shares in a holiday property letting business (Company A) and McIlroy owns 100% of the shares in a golf club manufacturing company (Company B).

Company B has struggled recently and survives solely because of a sizeable loan provided to it by Company A.

No tax planning arrangements exists between the two companies and so they would not previously have been associated. However, the loan makes them 'substantially commercially interdependent' and therefore associated.

The ability to make this election ensures that the two companies can avoid any retrospective disadvantage – in other words, if the companies each have a 30 June year end, the amendment would

normally take effect for the year ended 30 June 2011, but, by making the election, their association is deferred for 12 months.

Contributed by Robert Jamieson

Planning with the reduced Annual Investment Allowance

The limit for AIA reduces from £100,000 to £25,000 from April 2012 (1 April for companies, 6 April for income tax businesses). It is worth thinking carefully, not only about timing of expenditure, but also about accounting dates, if the client intends to incur substantial expenditure.

The way in which the limit operates for a period spanning 1 or 6 April 2012 is logical, and involves splitting the period into two across the date of change. The limit for the entire accounting period is then found by time apportioning the old and new limits as follows :

Year ended 30 June 2012 (income tax)

Period 1 Jul 2011 to 5 Apr 2012:	
280 days / 366 x £100,000	76,503
Period 6 April 2012 to 30 June 2012:	
86 days / 366 x £25,000	5,874
Total AIA for the period	£82,377

However, Clause 11 of the Finance Bill reveals that the maximum amount of AIA applying to expenditure in the period after the change is limited to the time apportioned limit for that part of the period. This approach has been used in previous changes of the limit but as the limit has increased it has not been a real issue. Now that the limit reduces it presents quite a practical problem – as the illustration below shows.

Although the limit for the year ended 30 June 2012 is £82,377 (see above) this full amount cannot apply to expenditure between 6 April and 30 June. The maximum expenditure that can qualify for AIA between 6 April 2012 and 30 June 2012 is £5,874. Indeed if this client incurs no expenditure between 1 July 2011 and 5 April 2012, the maximum allowance for the year ended 30 June 2012 would be £5,874. (Reference Finance (No 3) Bill 2011 Clause 11(7) – passed at Committee stage on 14 May 2011).

Where an income tax business needs to incur substantial expenditure in the period up to 5 April 2012, it may be sensible to draw up accounts for the period ending 31 March (or 5 April) **2011**. This may restrict the availability of allowances in 2010/11, but will then leave a complete year as the last period under the £100,000 limit, allowing expenditure of up to £100,000 to qualify for AIA claim for 2011/12. This is probably not a sensible option for a company due to the formalities associated with change of accounting date.

For an income tax business, provided the tax return for 2011 has not yet been filed, and the business has not changed accounting date in the last five years (unless it is in the first three years of trade) there should be no issues with changing accounting date to get the best result from the change in the limits for AIA.

Rebecca Benneyworth writing in AccountingWeb, 20 May 2011

Corporation tax on gains (Part 2) (*Lecture B659 – 18.14 minutes*)

This article reviews the differences in computation between CGT – the tax on gains paid by individuals and trusts – and corporation tax on gains which is paid by companies. The first part examined:

- the development of the differences between CGT and CT;
- an overview of the differences between the two regimes;
- the calculation of indexation allowance;
- share identification rules for companies;
- dealing with a reorganisation or takeover where there is more than one pool of shares held by a company.

This part examines:

- the computation of the indexed pool of post-1982 acquisitions;
- the computation of the 1982 pool holding;
- the "kink test" which must be applied when considering pre-1982 holdings.

Tax practitioners who mainly deal with CGT, but learned the tax before 2008, will be at least familiar with how these computations work. Increasingly they will become specialist knowledge for those who deal with gains made by companies.

Detailed points of share identification

Where a company held quoted shares at 6 April 1965, it may have made a "pooling election" in respect of them. Where a company held any chargeable assets at 31 March 1982, it may have made a "rebasing election" in respect of them. These elections are now likely to be out of time for making any changes, but their effect should be understood. They will continue to be relevant for as long as there remain companies which own something that they have held for that long.

The values at 6 April 1965 and 31 March 1982 are used for the "kink test", which is described further on.

Rebasing election

A "rebasing election" deems the taxpayer to have sold everything for its market value on 31 March 1982 and then to have immediately reacquired it for the same price. This means that the original cost has to be ignored for all purposes.

This is to the taxpayer's advantage if the MV82 was higher than the original cost, but the value fell afterwards – without a rebasing election, "the smaller of two losses" or "no loss no gain" would apply. With a rebasing election, only the MV82 is considered, so the allowable loss is not restricted.

However, the rebasing election affects *all* chargeable assets held on 31 March 1982. The taxpayer cannot select some. It will therefore be disadvantageous where the market value in 1982 was lower than the original cost, and rises subsequently. Not only will "the higher of the two gains" be chargeable instead of the smaller, but also the IA will be based on the smaller of the two figures. The election is irrevocable once made.

As well as changing the base cost, the rebasing election also affects identification. If a pooling election (see below) had not been made, any shares acquired before 6 April 1965 would be identified separately. However, a rebasing election would suppose a sale of all shares held on 31 March 1982, followed by an immediate reacquisition. The pre-April 1965 shares would therefore become part of a single 1982 pool, all acquired on 31 March 1982, all at the same value.

An election had to be made:

> within two years of the end of the first accounting period…
>
> …in which the taxpayer disposed of a chargeable asset to which the election could apply, i.e. one held on 31 March 1982…
>
> …where the disposal took place after 31 March 1988.

It is therefore now quite unusual for any company still to be able to make the election – for most companies who owned chargeable assets on 31 March 1982, they will have made a disposal of such an asset some time after 1 April 1988 but more than two years ago, and cannot therefore make an election any more.

Pooling election

The pooling election allows the taxpayer to put all quoted shares held on 6 April 1965 into the pool of shares acquired after that date at their value on that date. This affects both the identification of disposals with acquisitions (they move from "before 1965" to "part of the 1982 pool") and the calculation of the cost of those acquisitions (original cost is then ignored).

A separate pooling election was available for fixed interest securities and for ordinary shares.

The original pooling election was introduced in 1968, and had a similar "two years or too late" time limit to that described above. In 1988, a second chance was given to those who had not previously made the election – the rules being exactly the same as for the rebasing election. Again, it is now likely that any possible pooling election will have been made, or missed, before now.

Where a company has made a rebasing election, the pooling election becomes irrelevant – all the assets which could have been subject to a pooling election will effectively be pooled, because the pre-1982 assets will become a single asset sold and bought back on 31 March 1982.

So it is possible:

- to have made neither a pooling nor a rebasing election – three sets of assets, pre-1965 with 1965 kink test and 1982 kink test/1982 pool with 1982 kink test/post-1982 pool;
- to have made a pooling election but not a rebasing election – two sets of assets, 1982 pool including pre-1965 assets with 1982 kink test/post-1982 pool;
- to have made a rebasing election – two sets of assets, 1982 pool including pre-1965 assets with no kink test/post-1982 pool.

As for rebasing, the pooling election loses any significance for CGT from 6 April 2008. Compulsory rebasing to 1982 and pooling of all holdings means that it will no longer make any difference.

Calculating costs: several acquisitions

Life is more complicated if there have been several acquisitions. The first step is to identify the disposal with acquisitions within given periods set out above. Then the cost must be calculated separately for each element of the disposal.

The proceeds are apportioned between the different elements of the disposal in proportion to the number of shares in each part.

S.104 holding

Acquisitions in this period are pooled with each other. A running total is kept of number of shares, total cost and indexed cost.

Indexation (using "unrounded" indexation factors, if the taxpayer wants) is added to the total of the indexed cost pool every time a cost was added to the pool, or some cost is deducted from the pool on a disposal. It was therefore added on a purchase, a rights issue or a sale, but not on a bonus issue (which changes the number of shares but adds nothing to the cost).

Rights and bonus issues on pool shares are added to the pool, but only a rights issue (where there is a cost) leads to an adjustment for indexation at that time. Scrip dividends, if they are received by a company, are not charged to tax on income so they do not affect the base cost for gains.

When shares are sold from this pool, a proportion of the cost (and indexed cost) is deducted from the amounts to carry forward. This proportion is the same as the fraction of the shareholding that has been sold – where 6,000 of 10,000 shares have been sold, 60% of cost and indexed cost are taken. The amount taken out of the pool is deducted from proceeds to compute the chargeable gain.

It is necessary to identify the cost and indexed cost separately because the difference is IA – and this is not allowed to create or increase a loss. In practice, it is only necessary to identify the unindexed cost if the computation produces a loss. If it produces a gain anyway, the indexed cost is all that is needed.

The sale of rights from a pool is dealt with in the same way by a company as by an individual – a proportion of the cost is used up using "A over A plus B", where A is the cash received and B is the value of the holding after the rights issue. Small part disposals (A is less than £3,000, or A/A+B is no more than 5%) can also be dealt with in the same way as for individuals, by using enough cost to wipe out the proceeds at this time (resulting in a lower cost carried forward and a higher gain in the future).

1982 pool

The 1982 pool has two "costs":

1. MV 31 March 1982 of the shares held on that day;
2. pooled, unindexed cost of the shares held on that day (preferably taken from the files, rather than recomputed – if there were prior disposals before 6 April 1982, different identification rules applied to determine what remains).

When shares are sold from this holding, a proportion of these two costs is taken out of the pool and put into the gains computation. Strictly, IA should be calculated in the gains computation rather than in the pool. It will be based on the higher of the original cost and the MV82.

The balance of the pool cost is carried forward for future disposals.

Note that the pool is "frozen" at 31 March 1982: it is not affected by subsequent market acquisitions, and (with one rather large exception) the cost can only be *reduced* by future disposals.

Traditionally, it was regarded as "correct" not to index the 1982 pool, but to index the cost taken out of the pool on a disposal. However, many people index this pool in the same way as the s.104 holding, and the results are very similar.

It will still be necessary to keep track of the cost and the IA separately, because IA cannot create or increase a loss. The "strict" approach identifies the IA in the computation, so it is easier to see that it must be restricted.

Pre 1965 acquisitions

Pre 1965 acquisitions are not pooled with each other: gains and losses are calculated separately for each individual acquisition.

However, if a "pooling election" or a "rebasing election" has been made, these acquisitions are treated as part of the 1982 pool, and there are no pre 1965 holdings.

Pre 1982 holdings: the kink test

The "kink test" is a computational aspect of the rebasing of base costs to market value at 31 March 1982. It means that a gain can be computed on the higher of original cost or MV 82; but a loss is computed on the *lower* of the two figures. The kink test was abolished for CGT for disposals from 6 April 2008 onwards. It will continue to apply for companies.

Where there was a single acquisition before 6 April 1982, the computation requires a comparison of the gain on two bases:

- the actual cost is deductible;
- the market value on 31 March 1982 is deductible.

However, the *higher* of these two figures is used in *both* computations for the calculation of IA. The IA factor is rounded to three decimal places. If the result is two gains, the smaller is chargeable.

Example	*Cost*	*MV82*
Proceeds 10 September 2010	90,000	90,000
Costs of disposal	– 1,000	– 1,000
	89,000	89,000
Acquisition cost 15 August 1974	– 20,000	
Market value 31 March 1982		– 28,000
IA to September 2010: 1.836	– 51,408	– 51,408
Chargeable gain	£17,592	£9,592

The chargeable gain is £12,000 (the smaller of the two figures).

The IA in each column is the factor (based on RPI for September 2010, 225.3, and RPI of 79.44 for March 1982) times £28,000 (the higher of the two figures).

If the result is two losses, indexation is restricted and the smaller loss is allowable.

Example	*Cost*	*MV82*
Proceeds 10 September 2010	40,000	40,000
Costs of disposal	– 1,000	– 1,000
	39,000	39,000
Acquisition cost 15 August 1974	– 50,000	
Market value 31 March 1982		– 58,000
Allowable loss	– £11,000	– £19,000

The allowable loss is £11,000 (the smaller of the two figures).

The IA is not allowed to create or increase an allowable loss, even if there is also a "s.104 holding" of the same shares on which there is a gain.

If the result is a gain and a loss, there is no chargeable gain and no allowable loss. This is also the case where the result is a loss and nil, or a gain and nil.

Example	*Cost*	*MV82*
Proceeds 10 September 2010	90,000	90,000
Costs of disposal	– 1,000	– 1,000
	89,000	89,000
Acquisition cost 15 August 1974	– 20,000	
Market value 31 March 1982		– 35,000
IA 1.836 x 35,000	– 64,260	– 54,000
Gain/loss	£4,740	£NIL

The chargeable gain is nil – one gain, one "nil". IA is restricted in the "market value" column. The IA is again estimated for September 2010.

Pre 1965: "double rebasing"

The following rule has rarely applied either for CGT or corporation tax in recent years. From 6 April 2008, it will only apply to corporation tax in any case – compulsory rebasing to 31 March 1982 for CGT (abolition of the kink test) will apply to all assets owned on 6 April 1965 as well.

The rule which remains for corporation tax is as follows.

If the asset was purchased before 6 April 1965, and there is no pooling or rebasing election in force, *in theory* it is necessary to consider:

- the gain computed using actual cost of acquisition;
- the gain computed using market value (*mid-market*) on 6 April 1965;
- the gain computed using market value on 31 March 1982.

Although this is required in theory, in practice the "market value 1982" gain will normally be the right one.

However, it is necessary to know the rule in order to spot the exceptional case where it does not apply.

Indexation is computed:

- in the "cost" column, on the higher of cost and MV 1982;
- in the "MV65" column, on the higher of MV65 and MV82;
- in the "MV82" column, on the highest of the three values.

The rules are largely incomprehensible, but have the following effect:

- the smallest of three gains is chargeable (typically, based on MV82);
- the smallest of three losses is allowable;
- if there are gains and losses in any combination, or any of the results is nil, there is neither an allowable loss nor a chargeable gain.

Example	*Cost*	*MV65*	*MV82*
Proceeds 10 September 2010	90,000	90,000	90,000
Costs of disposal	– 1,000	– 1,000	– 1,000
	89,000	89,000	89,000
Cost 15 August 1964	– 20,000		
Market value 6 April 1965		– 23,000	
Market value 31 March 1982			– 28,000
IA	– 51,408	– 51,408	– 51,408
Chargeable gain	£17,592	£14,592	£9,592

The chargeable gain is £2,000 (the smallest of the three figures).

The IA in the first two columns is the factor times the higher of the figure in that column and MV82; in the MV82 column, it is the factor times the highest of the three.

If there was a pooling election in force, the "MV65" and "MV82" columns would be compared, and the original cost would be ignored. If there was a rebasing election in force, only the last column would be considered.

In all cases, the chargeable gain in this example is the same, because it will always be based on the March 1982 value. Companies which have a lower current value than they had in April 1965 or March 1982 are relatively rare, except where they go out of business.

The rules for pre-1965 acquisitions of nearly all other chargeable assets, including unquoted shares, require the gain to be time apportioned to the period of ownership before 6 April 1965 (exempt, because CGT was introduced from that date) and after 6 April 1965 (chargeable).

Rollover and rebasing

Where:

- an original asset was acquired before 31 March 1982; and
- a gain was realised on a disposal between 1 April 1982 and 31 March 1988; and
- that gain was rolled over against the acquisition of another asset (e.g. on replacement of business assets);
- then it is possible to claim that only half the "frozen gain" is charged when the second asset is disposed of after 31 March 1988. This is to reflect the intention that pre-1982 gains should not be charged on post-1988 disposals.

Example

If a new freehold building was acquired for £500,000 in 1986, and a gain of £200,000 on disposal of a previous building was rolled over against the cost at that time, a sale of the building in 2011 would use a base cost of £300,000 (indexed from 1986 to the present).

If the first building had been bought before 31 March 1982 (whether 1 day or 30 years before), the company could claim to reduce the base cost in 2011 by only £100,000 – the 1986 cost would therefore increase to £400,000, indexed from then to the present.

Debt instruments

It is important to appreciate that certain transactions which give rise to capital gains for individuals and trusts are treated quite differently for companies. These include:

loan relationships such as loan stocks and debt instruments;

foreign exchange differences on monetary assets and liabilities.

"Normal" debt instruments

A "normal" debt instrument is one that is:

- a UK government security, or
- a corporate or other debt instrument which is:
  - denominated in sterling;
  - not convertible into shares or other chargeable investments;
  - not a "relevant discounted security", which is chargeable to income tax on disposal;
  - a commercial loan.

Rules for companies

Companies are treated as realising *income* profits or losses when they dispose of these debt instruments. They are exempt from CT on *gains*, but will be subject to CT on *income*. This means that gains on these types of security are taxable, but losses are also eligible for relief.

If the company operates a "mark to market" policy in its accounts to value its book of investments at the year end, any loss or gain arising is taxable or relievable, based on the figures included in the accounts (i.e. a *disposal* is not required to trigger the charge or relief).

In effect, gains and losses will be taxed in much the same way as interest payable and receivable.

"Unusual" debt instruments

Although "unusual" debt instruments are taxed quite differently for individuals (being chargeable to CGT rather than exempt), the difference is less significant for companies. As a general rule, they are taxed on "unusual" debt instruments in the same way as for QCBs and gilts – everything is *income*.

Foreign currency

The treatment of foreign currency exchange differences is an important difference between CGT and corporation tax:

- on monetary assets, an individual is typically chargeable to CGT on gains and losses using the rule in *Bentley v Pike*, whereas a company will calculate gains and losses in accordance with its accounting policy and will treat the result as income;
- on liabilities, an individual generally enjoys no relief for exchange losses and is not chargeable to tax on gains, but the same computation will apply to companies which will therefore be chargeable to tax on income (subject to rules on hedging which are beyond the scope of this lecture).

On non-monetary assets, a company is still subject to the rule in *Bentley v Pike* – the cost and proceeds of the asset in foreign currency are converted into sterling at spot rates and the gain computed in sterling accordingly. Only UK RPIs are used for indexation, even if it might make more sense to use the local measure of inflation in the country concerned.

Contributed by Mike Thexton

Value Added Tax

Online returns

HMRC have announced that some businesses are still filing VAT returns on paper, even though they are required to file online (i.e. were registered before 1 April 2010 or have a turnover above £100,000).

From April 2011, there will be a penalty for continuing to file on paper when an online return is required:

Annual VAT exclusive turnover	Penalty
£22,800,001 and above	£400
£5,600,001 to £22,800,000	£300
£100,001 to £5,600,000	£200
£100,000 and under	£100

Working Together 21

It was also announced in the Budget that **all** remaining traders will be required to file online from 1 April 2012.

Late registration (old rules)

A plumber was issued with a notice of compulsory registration backdated by over 30 months following an enquiry by HMRC. A penalty of 15% was levied, reduced by 25% for cooperation. A further reduction of 25% was agreed after the trader offered "very sad personal reasons for the non-registration", but HMRC refused to mitigate the penalty any further.

The Tribunal agreed that HMRC's decision was reasonable. The plumber's claim that failure to register had been the fault of his accountant was dismissed: it was the trader's primary responsibility to be aware of the threshold and the rules about exceeding it.

First Tier Tribunal (TC00899): *Brian McAdam Plumbing and Heating*

HMRC have issued a new version of Notice 700/41 which explains the operation of the old s.67 penalty. This will continue to apply where the failure to register arose before 1 April 2010. The notice has been restructured to improve readability, but the technical content has not changed significantly since April 1995.

Notice 700/41

Time limits

A trader failed to register for VAT. HMRC assessed periods covering a total of 9 years, and the trader appealed on the grounds that some of the assessments were invalid because they were out of time. The Tribunal confirmed that HMRC had 20 years to raise an assessment in the circumstances of the case. VATA 1994 s.77(4) extends the normal 4 year (then 3 year) deadline to 20 years where a penalty under s.67 (belated notification) could be issued. Here, HMRC had decided not to levy such a penalty, but it would certainly have been possible so the extended deadline applied.

The trader also argued that HMRC had had all the information required to raise the assessment for more than a year, because he had submitted SA income tax returns showing turnover above the registration thresholds throughout the period since 1999. The Tribunal agreed with HMRC's argument that this on its own was not "sufficient knowledge". The significant events were notes

between investigating officers in the Hidden Economy Team confirming that the trader had not registered for VAT and had reported turnover above the limit. These dated from 2008, not 1999.

A further hearing will consider the amount of the assessments now that their validity in principle has been established.

First Tier Tribunal (TC00733): MR Rastegar (t/a Mo's Restaurant)

Old penalties updated

HMRC have issued an updated version of Notice 700/42 *Misdeclaration penalty and repeated misdeclaration*. It explains how HMRC calculate and notify the penalties under s.63 and s.64 VATA 1994.

Even though these penalties no longer apply to current periods, they can still be levied while periods before 1 April 2009 are "in time" for enquiry and assessment.

The new penalties apply to periods which commenced from 1 April 2008 onwards, where the filing date fell after 1 April 2009.

In practice, this is likely to mean that quarters to 28 February 2009 are the last to which the old penalties apply.

Notice 700/42

Late notification of option to tax?

The Appellant was appealing against a decision, notified by the Commissioners on 16 June 2008 and later confirmed on review dated 9 April 2009, to refuse to accept a belated notification of an option to waive exemption on two properties, the effective dates of the option requested being 1 March 2005 and 1 January 2008 respectively.

By letter dated 13 May 2008 from the Appellant's tax advisors, HMRC received a request to accept a belated notification of an option to tax in respect of two properties used as serviced office blocks, namely the Mill House Business Centre ("Mill House") in Castle Donnington, which opened in April 2005, and secondly the Schoolhouse in Derby, which was acquired in summer 2007. The letter also requested registration.

The advisers explained that Mill House had been acquired subject to VAT as the vendor had opted to tax. The Appellant's bookkeeper, who dealt with the raising and processing of invoices and the company's tax and VAT affairs, mistakenly believed that that obliged the Appellant to charge VAT to its tenants. On this misunderstanding therefore, all tenants from 1 April 2005, when the first office was let out, were charged VAT on their invoices.

Substantial sums had already been spent refurbishing both properties and the company would, the Commissioners were told, for much of 2005 and 2006 have been in a repayment position. A schedule was attached to the letter detailing, quarter by quarter, the output tax which would be due on the rental income and the input tax which would be reclaimed on the refurbishment. The schedule showed that in relation to Mill House, from 1 April 2005 to February 2008 output tax of £157,433.70 would be due against input tax of £86,703.79. In respect of Schoolhouse, no output tax was due, but input tax would be reclaimed of £51,601.28.

The letter went on to say that Mr Iqbal and his bookkeeper had become concerned towards the end of 2005 that no VAT returns had been received, but as neither of them was familiar with the VAT registration and accounting process they assumed that a single global return would be received upon which they would declare all outstanding output tax and reclaim their input tax.

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The request was considered by HMRC who, by letter dated 16 June 2008, turned it down, explaining in a letter the procedure for making and notifying an election, and considered first whether or not the Appellant had demonstrated on a balance of probabilities that it had exercised an option to tax at the relevant time. The view taken was that it had not. HMRC pointed to the absence of any written evidence and importantly the absence of any application to register for VAT. The actions of the Appellant were not consistent with someone who had opted to tax. The officer expressed concern that the Appellant had been charging VAT for over three years without accounting for it.

It was common ground that making a legally effective election to waive exemption is a two stage process, the first stage being to make the decision to opt to tax and the second being to notify such decision to the Commissioners. The notification has to be within 30 days of the decision or within such longer period as the Commissioners may in their discretion allow (Legislation then in force – paragraph 3(6)(b)(1) schedule 10 VATA 1994).

It was also common ground that the Appellant bore the burden of proof. It was HMRC's basic submission that given the vagueness of the evidence the Appellant had not discharged that burden. There was no satisfactory or clear evidence from which the Tribunal could conclude that a positive decision to opt had been made. It followed that if no decision had been made there could not have been an election and HMRC had acted reasonably in refusing to accept the Appellant's request for acceptance of a belated notification.

The Tribunal did not accept that the appellant had opted to tax, and therefore the appeal was dismissed.

Mill House Management UK Ltd TC00960

VAT toolkits: technical note (*Lecture B660 – 16.59 minutes*)

HMRC have published a number of "toolkits" which are described as follows on the HMRC website:

> These toolkits provide guidance on areas of error that HM Revenue & Customs (HMRC) frequently see in returns and set out the steps that you can take to reduce those errors.
>
> They should help you to:
>
> - ensure that returns are completed correctly, minimising errors
> - focus on the areas of possible error that HMRC consider key
> - demonstrate reasonable care
>
> The toolkits will be updated at least annually.
>
> Follow the links below to access each of the available toolkits. The toolkits are available for download only.

They are found in a section of the website that is aimed particularly at agents and advisers (http://www.hmrc.gov.uk/agents/prereturn-support-agents.htm). The idea appears to be that agents and advisers will use them in reviewing their clients' records and returns before submission. While that might well be a good thing to do, I am not sure how many clients will pay their advisers for this sort of work.

There are three toolkits that relate to VAT:

1. input tax;
2. output tax;
3. partial exemption.

Anyone who trained as an auditor will recognise the format – they are like an audit "internal control questionnaire". The questions in the checklist are probably too "high level" and general to be useful, but the discussion of "risk" and "mitigation" underlying the questions is useful:

- for understanding how errors can arise and can be minimised;
- probably, for predicting how a control officer will go about an inspection – as these checklists are based on errors that HMRC commonly find, we can also expect them to reflect what officers commonly look for.

HMRC comment that use of the toolkits will be taken into account in deciding whether a taxpayer has "exercised reasonable care" where an error has occurred and penalties are in question. It is perhaps too optimistic to suppose that someone who has asked their advisers to carry out work of this type probably will not have any errors in the returns; people with errors are unlikely to have paid for this kind of service.

The content of the three VAT toolkits is summarised below.

Input tax toolkit

The section on "risks" is a good indication of what a visiting officer will look for:

Record keeping

Good record keeping is essential, as poorly kept records can mean that the VAT Return is prepared on the basis of inaccurate or incomplete information. Where a business operates from more than one location it is also important that procedures are in place to ensure that all relevant accounting information needed for completing the return is reported to the person that prepares it in time for inclusion on the return.

For further information on record keeping see Record keeping fact sheet.

Even when records are well kept, mistakes, duplications and omissions may occur, resulting in input tax being claimed too early, too late or in the incorrect amount. If a computer package is used to calculate VAT Return values, care should be taken to ensure that correct date ranges are set and that all relevant transactions within the period date range are included.

The requirement to add back input tax if the related expenditure remains unpaid six months after the date of the supply or the due date for payment (whichever is the later) is also often overlooked.

Private and non-business use

In many businesses personal and business finances can be closely linked and input tax may be claimed incorrectly on expenditure which is partly or wholly for private or non-business purposes. 'Business purpose' can be a complex area in relation to input tax.

For further guidance see V1-13 Input Tax section 4 and V1-6 Business / Non-Business.

When expenditure has a mixed business and private/non-business purpose the related VAT should generally be apportioned and only the business element claimed. Under the Lennartz approach when a business purchases an asset, or services resulting in the construction of a new asset, which has mixed business and private use (but not mixed business and non-business use other than private use), the VAT may currently be claimed in full at the time of purchase but output tax must subsequently be declared to reflect private use. The application of the Lennartz approach to new purchases of land, property, boats and aircraft will be restricted from 1 January 2011 – see Q8.

When goods on which a business has claimed input tax in full (such as an item of stock or an office computer) are subsequently put to private or non-business use, there is a deemed supply for VAT purposes and output tax is normally due on the cost of the supply. The deemed supply is one of goods if the change of use is permanent and of services if temporary.

Partial exemption

When a business has expenditure which relates wholly or partly to existing or intended exempt supplies it becomes partly exempt and can only claim the related input tax if it is below the prescribed de minimis limit. For a list of exempt supplies which are commonly made see Q9.The partial exemption standard method determines how much input tax can be claimed unless an individual special method has been approved by HMRC.

Many businesses do not recognise that they are partly exempt or carry out partial exemption calculations incorrectly, for example by using an unapproved special method or by omitting to carry out a longer period calculation.

If certain assets (computers or land/building works over specified values) have been purchased for use in the business, those assets are subject to adjustments under the Capital Goods Scheme (CGS) to reflect changes in the degree of taxable use. The need to consider CGS adjustments is often overlooked.

Business entertainment

Input tax is often claimed in error on the provision of business entertainment. Business entertainment includes the provision of hospitality or entrance to theatres, concerts and sporting events and similar expenditure. Entertainment costs analysed to expense headings such as advertising or marketing are often overlooked and the related VAT claimed in error.

Cars and motoring expenses

Input tax errors frequently occur in relation to the purchase or lease of cars and to motoring expenses in general. Input tax cannot be claimed on the purchase of most cars while the recovery of VAT incurred in leasing a car which is available for private use should generally be restricted to 50 per cent. If a business supplies fuel for cars, an output tax scale charge is generally due for each car unless records are maintained to demonstrate that fuel has only been provided for business journeys. Input tax claimed in respect of business mileage payments must be restricted to the fuel element of the mileage rate and be supported by original fuel purchase invoices.

International transactions

There are distinct mechanisms for the payment and recovery of VAT on goods purchased from suppliers outside the EU (imports) and inside the EU (acquisitions). If these are not applied correctly input tax error can result.

The purchase of many services from overseas suppliers requires the UK recipient to account for both output tax and input tax on the supply (the reverse charge), applying any appropriate restrictions to input tax recovery – this requirement is often overlooked or incorrectly performed.

The checklist itself has clickable links which take the user to more detailed discussion of what the questions mean. The whole questionnaire is reproduced below, together with the further information which relates to the first question.

The questionnaire

		Yes	No	N/A
Record keeping				
1	Have input tax records been reviewed for posting errors?			
2	Is satisfactory evidence held to support input tax claims?			
3	Have the records been reviewed to ensure that input tax has been claimed at the correct time?			
4	Has input tax claimed on expenditure which remains unpaid after six months been added back?			
Private and non-business use				
5	Has input tax been restricted appropriately on expenditure for private purposes?			
6	Has input tax been restricted appropriately in respect of non-business activities?			
7	Has VAT incurred on expenditure with mixed business and private/non-business use been correctly adjusted?			
8	Have Lennartz output tax adjustments been made if required?			

		Yes	No	N/A
Partial exemption				
9	Have partial exemption calculations been carried out correctly if required?			
10	Have Capital Goods Scheme adjustments been carried out correctly if required?			
Business entertainment				
11	Has the recovery of input tax on business entertainment been restricted?			
Cars and motoring expenses				
12	If a car has been purchased has input tax recovery been restricted appropriately?			
13	Has input tax been restricted appropriately on the lease or long-term rental of cars available for private use?			
14	Has input tax been claimed correctly on the purchase of fuel for cars?			
15	Has input tax been correctly adjusted in respect of vehicles other than cars which are available for private or non-business use?			
16	Has input tax been claimed correctly on business mileage payments to employees?			
International transactions				
17	Has input tax been claimed correctly on goods imported from outside the European Union?			
18	Has acquisition tax on goods acquired from a supplier in another European Union member state been declared correctly?			
19	Has input tax been accounted for correctly on services received from overseas suppliers?			

Examples of supporting material – Q1

1. Have input tax records been reviewed for posting errors?

Risk

Many input tax errors are the result of misposting or misunderstanding when transactions are first entered in the records. See explanation below for a list of common errors.

Mitigation

A general review of input tax postings prior to submission of the VAT Return will often identify and eliminate many common errors.

Comparing the tax and net summary totals may also highlight any significant mispostings. Compare the calculated input tax to the amount claimed on the last return or on the return for the same period last year and consider whether any significant variations are consistent with your understanding of the business and its development.

Explanation

Common errors include:

- Duplicated claims – particularly where requests for payment or pro-forma invoices have been received.
- Manual, arithmetical and consolidation errors.
- Input tax incorrectly calculated on VAT inclusive amounts.
- VAT and net values transposed.
- Input tax incorrectly calculated for VAT reduced-rate purchases or transactions subject to a settlement discount.
- Input tax claimed on purchases which do not carry VAT (such as stamps, train/air/bus tickets, some tolls – see Update 1 to notice 700 the VAT Guide, tea/milk/coffee, cash withdrawals).

- Input tax claimed on costs incurred outside the UK (for example conference/business trip accommodation and meals) - see below.
- Insurance Premium Tax (IPT) claimed as input tax.
- VAT Return and assessment payments claimed as input tax.
- Purchase credit notes incorrectly posted.
- Self-billed sales invoices on which output tax is due posted as purchase invoices.
- Input tax claimed on costs proper to a third party – for further information see VATSC9000 – Direction of supplies.

Some computer accounting packages have integral VAT audit functions which can assist in identifying potential errors before a return is submitted.

While VAT incurred in other EU states cannot be claimed as input tax, it may be recoverable from the relevant national authority.

For further information see UK businesses visiting other EU countries – getting VAT refunds.

Output tax toolkit

	Record keeping	***Yes***	***No***	***N/A***
1	Have output tax records been reviewed for errors and omissions?			
2	If the Flat Rate Scheme has been used, has it been operated correctly?			
	Supplies and liability			
3	Have all occasional and miscellaneous supplies been included in the VAT Return calculation?			
4	Has output tax been accounted for on the disposal of assets when appropriate?			
5	Has output tax been declared correctly on any self-billed invoices received?			
6	If the business undertakes cross-border transactions, have the place of supply rules been correctly applied?			
7	Has the business applied the correct VAT liability to its supplies?			
8	Have supplies relating to land and buildings been treated correctly for VAT purposes?			
9	If the business has opted to tax land and buildings, has any related income been correctly treated?			
10	Is there supporting evidence for non-standard-rated supplies?			
	Time of supply			
11	Has output tax been declared at the correct time?			
12	If deposits have been received, has output tax been declared when appropriate?			
13	If the Cash Accounting Scheme is operated, has output tax been accounted for correctly?			
	Value and calculation			
14	Has output tax been calculated correctly on VAT-inclusive values, discounted amounts and mixed supplies?			
15	Where disbursements have been itemised, have they been included in the value of the supply when appropriate?			
16	Have delivery charges been treated correctly?			
17	If a retail scheme is operated, has output tax been calculated correctly?			

	Yes	No	N/A

Exports and dispatches

18 If goods exported outside the European Union (EU) have been zero- rated, has the specified evidence been obtained within the appropriate time limits?

19 If goods dispatched to business customers in other EU states have been zero-rated, has the specified evidence been obtained within the appropriate time limits?

Credit notes and bad debt relief

20 Have sales credit notes been correctly issued?

21 Have any adjustments for bad debt relief and bad debts recovered been made correctly?

Business gifts and deemed supplies

22 Has output tax been accounted for on business gifts when appropriate?

23 Has output tax been accounted for on assets put to private or non-business use?

Example of supporting material

An example of the explanatory notes is given below for the first question:

1. Have output tax records been reviewed for errors and omissions?

Risk

Output tax errors can occur as a result of omission, misposting or misunderstanding when transactions are first entered in the records. In particular, sales invoices dated towards the end of a VAT Return period can sometimes be overlooked - for example if the VAT Return report within a computerised accounting system has been run before all relevant sales invoices have been posted.

Mitigation

Consider whether all relevant supplies made by the business have been identified and whether the level of calculated outputs is consistent with levels of expenditure and your understanding of the business.

A general review of output tax postings prior to submission of the VAT Return will often identify and eliminate many errors and omissions. Comparing the calculated output tax and net outputs totals, or reconciling calculated outputs values to other available turnover information (for example in management accounts), may also highlight significant omissions, as may comparing calculated output tax to the amount declared on the last return or on the return for the same period last year.

If a computer package is used to calculate VAT Return values, care should be taken to ensure that correct date ranges are set and that all relevant transactions within the VAT period date range are included.

Some computer accounting packages have integral VAT audit functions which can assist in identifying potential errors before a return is submitted.

Explanation

Common output tax errors include:

- manual, arithmetical and consolidation errors
- omitted or duplicated invoices
- sales invoices posted gross without extracting output tax on standard or reduced rate supplies
- output tax incorrectly calculated on VAT-inclusive amounts or on supplies subject to a settlement discount
- incorrect VAT liability codes being set within a computerised accounting system
- VAT and net values transposed

- sales credit notes incorrectly posted

VAT Return calculations should include all business activities of the registered person. While a business may keep separate financial records for different aspects of its business for commercial or other administrative purposes (for example a building contractor owning a number of rental properties which maintains separate records for its construction and property activities), all of its supplies should be included.

For further information on what to include in each box of a VAT Return see VAT Returns: how to complete your VAT Return box-by-box.

(www.businesslink.gov.uk/bdotg/action/layer?r.l1=1073858808&r.l2=1083126673&r.l3=1083127324&r.s=tl&topicId=1081167159).

Contributed by Mike Thexton