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Personal Tax

Earnings of an employee?

H was the sole director and shareholder of the appellant company. In 2002 the appellant registered with an agency (D) to provide a manufacturing plant (J) with the engineering resource support of H. H was engaged by J between March 2003 to April 2007 under a series of short-term contracts, which ran consecutively, although both J and H terminated the contracts early on one occasion. H had to provide a suitably qualified replacement in the event he was prevented by illness or injury from performing his services. H did not work the fixed hours laid down for employees, but chose his own hours and he worked throughout the time the plant was closed down and took his holidays whilst the plant was operational, unlike the employees who had to take their holidays when the plant was closed down. He worked at the plant, alongside the employees, and was provided with a desk and computer, but he took in the rest of the equipment that he required. The manager would hand out the work but the way he carried out the work was up to H. HMRC took the view that the series of engagements under which the services of H were provided to J were subject to the IR35 legislation. They accordingly issued a decision that H should be regarded for the purposes of the Social Security Contributions (Intermediaries) Regulations 2000, SI 2000/27 reg 6(1) as an employee of J. HMRC also issued determinations that J was liable for income tax in accordance with FA 2000 Sch 12 and ITEPA 2003 Ch 8, Pt II during the same period. The appellant appealed.

The issue arose as to whether had the arrangements taken the form of a contract between H and J, H would have been regarded as an employee of J. HMRC submitted that the irreducible minimum necessary to establish a contract of employment—ie mutuality of obligation and of control—were present as (i) for each period of engagement there would have been an offer of work, an agreement to do that work, and an agreement to pay for it; and (ii) H was under a large degree of control; his position was in reality no different from that of a senior employee. H argued that (i) there was no mutuality of obligation. That was evidenced by the fact that H was sent home early when the computers went down and the early termination of the contracts; and (ii) the control had to be substantial enough to render the worker the servant of the master, and control to that degree was not present on the facts.

The tribunal found that there was no mutuality of obligation, and the degree of control which would have been needed to establish a contract of employment just did not exist. In sending contractors home when the computers went down, J demonstrated that it did not consider itself to be under any obligation to provide work or pay even after an offer had been made and accepted. Both parties demonstrated by their conduct in terminating contracts midway through their belief that the contracts could be terminated at any time without consequence. Examining the question of control as a whole and putting together all the individual factors which made it up, H was not subject to the degree of control which would be necessary to constitute a contract of employment. In reality the degree of supervision and direction exercised over what H was doing would be broadly similar to that exercised over all the other contractors and senior employees simply because the nature of the project demanded it. Management dictated what had to be done, but the way in which he did it was up to H. However, there were other aspects to control and it was in an examination of those that a clear distinction could be drawn between employees and contractors. H was subject to markedly less control than employees; no employee had H's flexibility of working hours—in practice he came and went as he wished, advising management only as a courtesy—and holiday leave. He went through no induction process and was not subject to appraisals; nor was he subject to the company's disciplinary or grievance process. He was under a contractual obligation to rectify errors at his own expense. The control to which H was subject was significantly less than that exercised over employees and demonstrated a clear distinction between the two. The appeal would be allowed.

Appeal allowed.

Marlen Ltd v Revenue and Customs Comrs TC 1264, [2011] UKFTT 411 (TC)

Specialist consultancy – employee or self-employed?

The appellant company was a small specialist consultancy working in the database software development field. W was the appellant's sole shareholder and director. Between 4 June 2001 to 14 March 2003 the appellant provided the services of W to its client (G) through the services of independent agency companies. HMRC issued a notice of decision that the appellant was liable to pay primary and secondary Class 1 National Insurance Contributions (NICs), pursuant to SSCTFA 1999 s 8 and the Social Security Contributions (Intermediaries) Regulations 2000, SI 2000/727, reg 6(4) in respect of W's earnings with G, amounting to 39,676.89. HMRC also issued two notices of decision under the Income Tax (Pay As You Earn) Regulations 2003, SI 2003/2682, reg 6(4) that the appellant was liable to pay £15,420.84 in relation to W's earnings. The appellant appealed. The issue arose as to whether, had W been engaged directly by G, he would have been regarded as an employee of G or as an independent contractor providing his services. The appellant argued that (i) the actual contracts between it and the agencies and the agencies and G were consistent with the services of W being provided to G as those of an independent contractor: they were for a specific task and for a specific period; they were for the provision of a specific person, but with a right to substitute another with equivalent skills; they allowed, within limits, the worker to undertake work for other clients during the contract period; and they took great care to provide that the worker should not be regarded as an employee of the client; (ii) as for the day to day reality, W had a great deal of autonomy as to the way he carried out his work, provided it fitted in to the overall workings of the project, and he had skills not otherwise available to G; the client regarded him as someone engaged for the short-term and for a specific project and in that regard different from an employee of the client; and (iii) he was paid on an hourly basis for work done, and had no employee benefits beyond the use of certain on-site facilities. HMRC submitted that the hypothetical contract between W and G would be one of employment as, inter alia, (i) on the question of the extent and degree of control, the issue was whether there was a right to control, not whether in fact that control was exercised. G had the right of control over what services were to be provided, and where and when those services had to be provided; the work was allocated and monitored by G. G had sufficient rights of control to render the hypothetical contract one of employment; and (ii) as regards the right of substitution, in practice W was engaged for the job and G, who had a veto right, would have been likely to resist any attempt by the appellant or agency to provide a substitute.

The hypothetical contract between W and G would have been on the following terms: (i) W's services would have been engaged for a series of fixed term contracts which nevertheless could have been terminated before the expiry of the term by four weeks' notice; (ii) W's services would have been specific and detailed; (iii) W would have been paid solely on the basis of a specified hourly rate for the number of hours actually worked; (iv) W would not have been entitled to any pension or insurance benefits, benefits in kind, or bonus, share options or other incentive arrangements provided to actual employees of G; (v) W, in providing his services, would have had to co-operate with G and take account of its directions; (vi) during the period of engagement W would have been entitled to undertake assignments for other contractors provided that there was no conflict with the interests of G and that there was no prejudice to the carrying out and the completion of the G project; (vii) the contract would have been for the engagement of services of W, but if he was unavailable for any reason he could have proposed a substitute for himself who might have continued with the project, provided that the substitute had comparable skills to W; (viii) there would have been no provision for training or other skills development for W other than a necessary and basic induction process; and (ix) there would have been a requirement that W provide at his own cost public liability and professional indemnity insurance cover for not less than £1m; and (x) it would have included a declaration that W was not an employee of G.

The nature of the engagement would have been that of an independent and self-employed contractor providing services to a contractor, and not that of an employee providing services to an employer under an employment contract. The pointers towards a contract for services included: the payment at the agreed rate for each hour of work; the substitution clause in the contracts. Any contract which had at least some recognition that the provider of services could supply a substitute in certain circumstances had to seriously be considered as being a contract other than for employment; the minimum supervision of W also pointed away from a contract of employment; the fact that W could undertake other assignments for other parties was an indicator of the relationship being that of independent contractor, and not that of employer/employee; the appellant was exposed to financial risk in a manner and to an extent that W would not have been exposed to had he been an employee;

and finally the fact that the appellant was in business on its own account and the services which it performed—including those it performed for G—were performed in the course of that business. It followed that the appeal would be allowed.

Appeal allowed.

Primary Path Ltd v Revenue and Customs Comrs TC 1306
[2011] UKFTT 454 (TC)

Was the car a pool car?

The taxpayers, a company and its managing director, claimed a car used by the director was a pool car and did not give rise to car benefit and fuel benefit charges.

The vehicle, a saloon car, was made available to the director, and fuel was supplied by the company. The director claimed the vehicle should be treated as a pool car because he was on 24-hour call, so effectively, there was no home-to-work travel.

He took the car to his home so that he could visit a site early rather than go to the office first. Furthermore, other employees could use the car, and the director owned two other vehicles.

HMRC disagreed, saying the car was available for the director’s private use. No mileage records were kept of journeys carried out by other employees.

The First-tier Tribunal found the director was the main user of the car and, rather than being permanently on call, he responded to occasional emergencies. The car was used for ordinary private commuting and did not constitute a pool car.

The taxpayer’s appeal was dismissed.

McKenna Demolition Ltd; Richard McKenna (TC1204)

No private fuel - No proof provided

The taxpayer claimed a Porsche Carrera S owned by his company was for his private use only, and the firm did not provide fuel; thus no car fuel benefit was due.

At an employer compliance review in 2008, HMRC asked about the company cars returned on the form P11D in respect of which fuel benefit had not been returned.

Fuel had been bought using a company credit card, but there were no records to show the fuel had been reimbursed to the employer.

The company claimed it did not pay for fuel bought for the Porsche but could produce no evidence. HMRC disagreed and amended the relevant assessments.

The company appealed.

The First-tier Tribunal said it was for the company to show HMRC were incorrect. The car was a company asset on which capital allowances had been obtained, but no business use was made.

The tribunal accepted the car was used only on private occasions, but found there was no evidence to support the claim fuel paid for using the company credit cards was used for business only.

The company’s appeal was dismissed.

J B Little (TC1184)

Cheshire Employer and Skills Development Ltd v Revenue and Customs Comrs [2011]

The taxpayer company employed training advisers whose role was to visit the premises of employers through the surrounding counties. They were therefore required to undertake a significant amount of travel which was practicable only by car. They were expected to use their own cars, and were paid certain sums intended do defray part of the cost of their doing so. There were two different relevant schemes. In one, the employee was paid a rate per mile. In that scheme no lump sum allowance was paid. In the other, the employee received a lower rate per mile and a lump sum. It was common ground that the payments per mile did not attract National Insurance contributions. However the taxpayer treated the lump sums as subject to National Insurance contributions. The taxpayer claimed it had overpaid tax, the National Insurance contributions in respect of the lump sums. The First-tier Tribunal (the tribunal) found that the lump sums were not stated in the salary, and concluded that if the lump sums were not earnings, they were relevant motoring expenditure, within the meaning of the Social Security (Contributions) Regulations 2001, reg 22A(3). The Revenue appealed.

The Revenue submitted that although the tribunal had identified that the lump sum payments had not been earnings in any event, it had not gone on to consider whether they represented relevant motoring expenditure within the meaning of reg 22 A(3). It had instead decided the appeal on the footing that if the payments were not earnings, they had to be motoring expenditure, which approach did not properly address the legislative test. It submitted that the tribunal should reconsider the decision, and that the payments had not been of relevant motoring expenditure as in the circumstances, they were not linked to use.

The tribunal had failed to determine whether the payments were of relevant motoring expenditure. There was nothing in the decision which suggested that the link between the payment an the use of the vehicles had been considered, as it ought to have been. In the circumstances, the payments were not of relevant motoring expenditure, and accordingly the taxpayer's claim for reimbursement had to fail.

Upper Tribunal (Tax and Chancery Chamber), Bishopp J, ***16 August 2011***

Were payments by trustees liable to NIC?

The appellant company established two discretionary employee benefit trusts for the benefit of its employees. The trustees included directors of the appellant and a trustee company. Following the sale of the parent company for £39 million, the trustees decided to make cash payments to certain employees, based on the appellant's bonus structure, although they also decided to make length of service a factor. To receive a payment, an individual had to be still in the employment of the appellant on the payment date and the eligible employees were informed by letter. The first set of payments at the end of October 2002, totalling some £1.35 million, and further payments were made in October 2003 and February 2004. One of the payments was paid to A, who was the appellant's director of commercial operations.

In November 2009 HMRC issued a notice of decision that the appellant was liable to pay primary and secondary Class 1 National Insurance Contributions (NICs) for the period 6 April 2003 to 5 April 2004, in respect of A as a representative case.

The appellant appealed.

The following issues arose for consideration whether

(i) the payments to A were “gratuities” within the meaning of the Social Security (Contributions) Regulations 2001, SI 2001/1004, Sch 3, para 5; and

(ii) there had been any allocation, directly or indirectly, of any payment by the appellant for the purposes of para 5(3).

A gratuity for the purposes of the 2001 Regulations, Sch 3, para 5 was a voluntary payment given in recognition of services rendered where the amount of the payment depended on the donor and where there was no obligation on the part of the donor to make the payment. Each payment had to be considered individually to see whether it satisfied the "gratuity" test. However it was not necessary to conduct a careful analysis of what services had been rendered and to whom; all that was required was to establish that a payment had been made because the recipient had performed some service for which the payer wished to show approval or gratitude (in contrast to the situation where the payer made a completely unsolicited payment out of the blue by reason, for example, of sympathy, admiration or natural love and affection). Furthermore it was clearly the state of mind of the payer and not the payee which was relevant to deciding whether a payment was given in recognition of services rendered). On the facts, all three element of the gratuity definition were satisfied. The trusts made voluntary payments to employees in a situation where there was no obligation to make that payment. The trustees exercised fully independent discretion in deciding on the distributions to be made, and in doing so they were deciding on payments which were voluntary and made in a situation where there was no obligation to make those payments. Although the creation of a link between receipt of the payments and continued employment with the appellant was an unexpected element of a gratuity and—when considered in the context of the hope of further payments which would have been engendered in the employees when they received the initial letter informing them of the "continuing employment" condition—came perilously close to undermining the "voluntary" status of the second and subsequent payments, that link was not sufficient to displace the view that the payments remained voluntary and were made in circumstances where there was no obligation to make the payment. It followed that the payments to A and, by extension, to the other employees, were gratuities; *Channel 5 TV Group Ltd v Morehead (Inspector of Taxes)* [2003] STC (SCD) 327 applied.

All the trustees concerned had been extremely careful to distinguish in their own minds the role and responsibility which they had in relation to the trust from their other roles and responsibilities for the appellant. The trustees did exercise their own independent judgment and did not simply go along with the appellant's views on the allocation. The bonus model as the starting point for the allocation was entirely logical and was simply a starting point. An extra factor—length of service up to the sale—was added into the equation. It followed that there was no allocation, direct or indirect, of any payment by the appellant. Accordingly the appeal would be allowed.

Appeal allowed.

Knowledgepoint 360 Group Ltd v Revenue and Customs Comrs TC 1291

[2011] UKFTT 438 (TC)

Disguised remuneration – what do the rules mean? (Lecture P676 – 16.00 minutes)

The disguised remuneration legislation is designed to look through arrangements between an employer, third parties and employees and their beneficiaries and take account of the effect on the employee.

Broadly speaking, if third-party arrangements are used to provide what is in substance a reward or recognition, or a loan, in connection with the employee's current, former, or future employment, then an income tax charge arises.

How the legislation works

HMRC published comprehensive guidance, for use by advisers and HMRC staff, in document form on 18 August 2011. This will be fully web-enabled in the *Employment Income Manual* in the early autumn.

This guidance sets out how the legislation works and includes examples of when charges will arise and how the exclusions work. The legislation works by a series of tests or steps to identify transactions that will be deemed to be employment income in the hands of the employee and income subject to the operation of PAYE in the hands of the employer.

Step 1. Is there a third party?

The legislation will not apply in a case where the employer is providing something directly to the employee, and there is no third party involved.

There are two exceptions where:

1. the employer is acting as a trustee.
2. certain steps are taken by an employer and there is an undertaking to pay contributions to a relevant third person that are not subject to the annual and lifetime restrictions on pensions tax relief.

Step 2. Are the ITEPA 2003 s 554A conditions met?

Step 2 involves answering three fundamental questions.

1. Is there an 'arrangement'? (Agreement, scheme, settlement, transaction, trust or understanding, whether it is legally enforceable or not).
2. If so, has a 'relevant third person' taken a 'relevant step'?
    - pays a sum of money, transfers an asset, or grants a lease which is likely to have an effective duration exceeding 21 years; and
    - does so in favour of a 'relevant person'.
3. Is that 'relevant step' connected with the arrangement in question? If the answer is no, then Part 7A does not apply.

Step 3. Do any of the exclusions apply?

If an arrangement has met the conditions in s 554A, that does not necessarily mean that it has given rise to a charge to income tax under ITEPA 2003, Part 7A.

Part 7A has a number of specific exclusions. For example, there is an exclusion whereby no step taken under a registered pension scheme can give rise to a charge to income tax under Part 7A.

Advisers will want to familiarise themselves with the guidance so that they can understand where a transaction or arrangement may give rise to a charge to income tax under Part 7A.

Example - EBT loan

Jane works for an employer in the UK. The employer contributes £100,000 to an employee benefit trust (EBT) which it established in Jersey for the benefit of its employees.

Having properly considered a request from the employer, the trustees of the EBT makes a loan of £30,000 to Jane's husband, Edward, in recognition of Jane's work over the previous year.

The EBT is an arrangement for the purposes of ITEPA 2003, s 554A [9] as the trustees are a relevant third person, and the loan is a relevant step within ITEPA 2003, s 554C [10].

The value of the relevant step that counts as Jane's employment income, and thus subject to PAYE, is the full amount of the sum paid by way of loan, namely £30,000.

Example – Existing loan

Robert received a loan from an EBT in 2009/10 which is left in place after 9 December 2010. The original loan does not give rise to a charge under ITEPA 2003, Part 7A [8], because the rules were not in force in 2009/10.

Assuming all the loan terms and everything about the arrangement remain unchanged, then nobody takes a 'relevant step' because nobody pays a sum of money, transfers an asset or grants a lease which is likely to have an effective duration exceeding 21 years.

While the loan remains outstanding, it is within the scope of the legislation on employment-related loans and may give rise to a taxable benefit within ITEPA 2003, Part 3 Ch 7 [11].

Pension considerations

For pension benefits funded from 6 April 2011, the income tax charge imposed by Part 7A generally applies to pension schemes as to other third party intermediaries. However, no income tax charge arises under Part 7A when the intermediary is a pension scheme subject to the annual and lifetime allowances.

The previous tax treatment of pensions and other retirement benefits paid out of rights dating from before 6 April 2011 is broadly being maintained. All pension income continues to be taxable under ITEPA 2003, Part 9 [12] and not under Part 7A.

Lump sum retirement benefits paid out of rights built up before 6 April 2011 and not charged under Part 9 continue to be taxable as payments of PAYE employment income, but under ITEPA 2003, Part 6 [13] Ch 2 and not under Part 7A.

Example – Pre-2011 lump sum rights

In April 2015, a retired employee Thomas has a £1m fund in an EFRBS available to be paid out as a lump sum rather than a pension.

The value of the fund at 5 April 2011 was £800,000. There have been no new employer contributions since 6 April 2011. The fund has grown to £1m solely as a result of investment income and capital growth.

The growth in the fund does not give rise to a charge to income tax under ITEPA 2003, Part 7A [8] because of the exclusions in ITEPA 2003, s 554Q [14] (which relates to income arising from an earmarked sum or asset) and ITEPA 2003, s 554R [15] (which relates to acquisitions out of earmarked sums or assets).

The EFRBS pays the whole amount as a lump sum to Thomas. There is no income tax charge under Part 7A tax on the payment of the lump sum because it is just and reasonable to apportion all of the lump sum to rights accrued before 6 April 2011 including the investment income and capital growth.

The lump sum is instead potentially liable to income tax as a relevant benefit received under an EFRBS, in which case it counts as employment income under ITEPA 2003, s 394 [16].

Tax charges arising under s 394 may be mitigated by the operation of extra-statutory concession A10 (which covers lump sum retirement benefits paid under overseas pension schemes in respect of foreign service) or, for non-UK residents, double tax treaties.

The legislation in Part 7A does not alter how double tax treaties apply to pension and other retirement income. Any payment to a non-resident individual that would previously have benefited from a double tax exemption from UK tax will continue to do so.

Chapter 3

Part 7A Ch 3 deals with cases where an employer, instead of paying contributions straight into a pension scheme which is not subject to the annual and lifetime allowances, sets aside funds or assets to provide or secure payment of future contributions to such a scheme.

Chapter 3 does not give rise to an income tax charge unless there is an undertaking for contributions to be paid to a third party intermediary in order to fund the provision of retirement benefits by the intermediary. In these circumstances a relevant step is taken if:

- an employer earmarks assets with a view to the contributions that are the subject of the undertaking being paid; or
- an employer otherwise provides security for payment of those contributions.

Example – Ruth's EFBRS

At the end of year 1 the employer gives an undertaking to make payments to an EFRBS equal to 25% each year of Ruth's entitlement to annual bonuses when she reaches the age of 65 or retires, whichever is earlier.

Ruth's bonus entitlement for year 1 is £100,000 and for year 2 it is £50,000.

The employer does not earmark a sum or asset with a view to paying the contributions. They do, however, provide security to the EFRBS trustees by granting them a charge over a business property worth around £1m (that is a property worth significantly more than the amount of the contributions it has undertaken to pay).

In year 1, the amount of the contributions that the employer has undertaken to pay is £25,000 and the asset that is the subject of the security is worth £1m. The value of the relevant step that counts as a payment of employment income subject to PAYE is £25,000.

On the anniversary of giving the undertaking the amount of contributions that the employer has undertaken to pay is £37,500 and the asset that is the subject of the security was worth £1m when valued in the past 12 months.

The value of the relevant step is £37,500, but £25,000 of this overlaps with the £25,000 that was the subject of the relevant step for year 1.

The value of the relevant step that counts as a payment of employment income subject to PAYE on the anniversary of the undertaking being given is therefore £12,500.

The future?

HMRC will continue to engage with advisers to understand any ongoing areas of concern, and will add to or revise the guidance as necessary to give as much clarity as possible.

Summarised from an article by Val Hennelly is deputy director, HMRC central policy

UK agreement with Switzerland re unpaid tax (Lecture P677 – 13.04 minutes)

What is it?

The UK and Switzerland have entered into an agreement whereby, from 2013, a withholding tax will be used to clear certain unpaid taxes relating to Swiss assets such as bank accounts (but also including certain assets held there such as bonds, currency, precious metals but not real estate) from both the past and going forward. The Swiss banks will pay the withholding tax to the UK but will not reveal details of who it is paid on behalf of, thereby retaining Swiss banking secrecy. The banks are to pay over Sfr 500m in advance to start with.

Sorting out the past

A withholding tax of between 19% and 34% of the total value of the Swiss account as at 31 December 2010 will be automatically levied.

The percentage will be based on a complex formula which will include variables such as how long the account has been held between 2003 and 2010 - hence 34% is more likely than not in cases where the account has been held for more than only 8 years or so.

31 December 2010 was chosen so that account holders who heard rumours of a possible deal did not have the chance to remove funds thereby reducing the amount on which the 34% is levied. There will also be provision for applying the withholding tax to monies added post 2010.

Once this has been paid, the funds on which 34% was levied will be deemed "cleared" for UK tax purposes and no further tax will be due. However, if funds had been withdrawn from the account between 2003 and 2010, those amounts will clearly not be part of the calculation as at 31 December 2010, hence they will **not** be deemed to be UK tax cleared and are still fair game for investigation.

This applies to all Swiss accounts, not just those which HMRC suspects contain tax tainted funds.

The way to avoid the withholding tax regime is to disclose all the Swiss accounts to be UK authorities. If there are irregularities these can usually be sorted out under a disclosure facility such as the LDF. If it is claimed that the accounts are clean, expect the usual probing from HMRC to verify that.

A further option is simply to leave Switzerland. However, under an Exchange of Information Agreement the Swiss will report this and tell HMRC the location where any funds are removed to. Hence expect more probing and possibly a discovery assessment to disprove.

The Future

Future earnings in the Swiss account will automatically suffer withholding tax as follows:

Capital gains – 27%

Dividends – 40%

Interest – 48%

The reason why those percentages are slightly less than the norm for a top rate tax payer is that the tax will be paid by the Swiss at banks before the normal 31January and 31 July due dates.

Non Domiciled individuals

Non Domiciled individuals can opt out of the withholding tax regime for sorting out the past. However, they must think carefully before doing so as, if the opt out is found to be incorrect (e.g. remittances have inadvertently been made) HMRC will at least levy vastly increased penalties and at worst will prosecute. Non domiciled individuals may therefore need a thorough review of their Swiss affairs before opting out.

Non domiciled individuals cannot opt out of the withholding tax regime covering future income and gains. However, if the individual can properly demonstrate to the bank that he/she is non domiciled then the withholding tax will only be applied to remittances of income/gains. Quite how the banks will be able to identify anything other than the most straightforward of cash remittances is not yet known.

Other matters

- Taxes covered are income tax, capital gains, inheritance tax and VAT.
- The agreement applies to anyone with a UK passport unless they can demonstrate they are not UK resident.
- HMRC will also be entering into an exchange for information agreement in order to help identify individuals with Swiss accounts. HMRC will be able to ask the Swiss if a named individual has an account in Switzerland or not; HMRC can do this five hundred times a year initially but there will be provision to increase this amount.
- There will be provisions to look through opaque structures such as shell companies.
- There will be various exclusions including anyone under enquiry (we do not know the definition of this yet) when the treaty comes into force.
- There will be an anti avoidance measure whereby if banks promote schemes to avoid the taxes due under this agreement the banks themselves will become liable for the tax avoided.

Summary

There are basically three options as follows:

1. Do nothing – suffer Swiss withholding taxes regarding the past and the future. This applies whether there is tax evaded or not, i.e. to all bank accounts operated by UK individuals.
2. Make a disclosure – any tax due will then be determined in the normal way, perhaps using the LDF. It should be remembered of course that the LDF is a very different agreement, being a disclosure facility that can be used to clear all UK tax problems, whether relating to Switzerland or not; the Swiss agreement is a withholding tax regime and will not cover previously withdrawn funds.
3. Leave Switzerland –this delays the inevitable given the report that will be made by the Swiss to the UK.

Overall my view is that, if there are irregularities to clear, use the LDF, which will be available in the majority of cases. This also gives more certainty and is unlikely to cost as much financially as 34% of the entire capital in the account, although this is possible.

HMRC has now confirmed that it will be "extremely active" between now and 2013 in an effort to get as many people under investigation as possible where appropriate, hence those individuals will not fall within the withholding tax regime (see the exclusions above) but will suffer tax at the normal rates of up to 50% plus a hefty penalty plus an intrusive and lengthy investigation. This reinforces the advice that anyone with tax problems should come forward and disclose using the LDF now.

Contributed by John Cassidy, PKF (UK) LLP

Stand-alone Business Angel Seed Investment Scheme (Lecture P678 – 12.13 minutes)

Up for consultation is a new scheme based on EIS but more narrowly targeted at the seed level and to business angels.

The possible structure will involve the following:

1. More flexibility around the use of debt instruments, whereas EIS covers subscriptions for shares only. There would however be a requirement that at least 70% of the investment is in shares, so as to meet EU state aid guidelines.

2. Rather than based on company size, number of employees and gross assets, as with EIS and VCT, the new scheme may enable a more accurate target for investor and company by way of identifying characteristics of an angel investor and seed-stage company.

3. BASIS relief could be available only where the company is in pre-trading stage and intending to use the funds raised to develop business concepts.

4. The annual investment limit is planned to be less than for EIS.

5. The definition of a business angel entitled to the new relief could include some of the following:
   - the individual (or as a group making joint investment as a syndicate) has invested in at least 4 seed stage companies, so as to demonstrate valuable experience and at the same time have a record of previous EIS investment
   - he is or will be a director of the company, or provide some other specified support or advice by reference to, for example, an expertise he has in a particular field

This is a real consultation exercise, rather than a document that seemingly represents a *fait accompli*, with 41 questions asked. At this stage it is worthwhile looking again at the basic EIS requirements, before considering possible tax mitigation using the new BASIS whilst not forgetting that the tax tail should not wag the commercial dog.

EIS tax reliefs

1. EIS relief is available at a fixed rate of 30% on a maximum of £1 million per tax year from 2012/13 (£500,000 for 2011/12) in respect of new equity investment in unquoted trading companies.

2. The aim is to provide a targeted incentive, with the tax attractions also including the right to CGT deferral if a chargeable gain is reinvested in a company which qualifies for EIS relief. The tax advantages are clear, but the risk and lack of control over the company's activities must be given prime consideration, something which will be even more of an issue under BASIS::

   - EIS income tax relief at 30%
   - After 3 years no claw-back of the EIS relief
   - After 3 years a sale at a profit is tax-free
   - After 3 years a sale at a loss gives rise to an income tax relief claim against income of the same tax year or preceding tax year, with the loss being net of the EIS relief
   - After 2 years the shares qualify for IHT business property relief
   - Possible deferral of a CGT liability arising on disposal of any chargeable asset

3. The investor must be a ***qualifying investor*** subscribing wholly in cash for fully paid-up ***eligible shares*** issued by a ***qualifying company***. A carry-back election can be made so as to treat the claim as relating to the preceding tax year.

Qualifying company for EIS

This requires all of the following conditions to be met, with recent changes resulting from the Government's concern that without them the new EC guidelines on state aid for risk capital would not be met:

- unquoted (AIM listing is unquoted for this purpose) when shares issued, and no arrangements exist to cease to be unquoted; if on issue arrangements exist for the company to become a wholly-owned subsidiary of a new holding company by way of a share exchange, that is acceptable provided no arrangements exist for the new company to cease to be unquoted
- carrying on a ***qualifying business activity*** for at least three years
- all the funds raised must be wholly used within two years of the share issue (or, if later, within two years of the commencement of a qualifying activity)
- gross assets of no more than £15 million immediately before the EIS issue (£7 million to 5 April 2012) and no more than £25 million afterwards by looking at the whole group (£8 million to 5 April 2012)
- the company cannot raise more than £10 million (£2 million to 5 April 2012) in any EIS scheme in the 12 months up to the date of the investment
- the company (or group) must have fewer than 250 full-time equivalent employees (50 to 5 April 2012)
- the company must have a permanent establishment in the UK
- where the EIS funds raised are used by a subsidiary it must be a 90% subsidiary carrying on a qualifying activity or holding or managing property for the group; or has no profits for corporation tax purposes and does not make investments – an indirect subsidiary of the parent company also qualifies, but the 90% test still has to be met
- any subsidiary of an EIS company can be only 51% owned, rather than 90%, other than subsidiaries whose activities benefit from the EIS money and property management subsidiaries

Qualifying business activity

All trades qualify unless they come within any of the following at any time within the three years from share issue (or, if later, three years from trading commencing). There is no problem, however, if the company carries on any outlawed activity to an extent which is less than 20% and is therefore insubstantial.

- dealing in land; commodities; futures; securities; other financial instruments
- dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution
- banking; insurance; money-lending; debt-factoring; HP financing or other financial activities
- leasing; letting ships on charter (other than oil rigs or pleasure craft); letting other assets on hire; receiving royalties or licence fees (other than by reference to film production or R & D activities)
- providing legal or accountancy services

- property development
- farming; market gardening
- woodlands (holding, managing, occupying); other forestry activities; timber production
- operating or managing hotels etc; or managing property used as such
- operating or managing nursing homes or residential care homes; or managing property used as such
- shipbuilding, coal production, steel production
- providing services or facilities for any trade etc substantially falling within any of the above heads, which is carried on by another person (other than a parent company) where one person has a controlling interest in both trades

Other qualifying activities are R & D or oil exploration which is intended to lead to a qualifying trade carried on by the company or subsidiary.

Planned to be included in the list of outlawed activities from 6 April 2012 is that which is substantially based around the receipt of feed-in tariffs under the Department of Energy and Climate Change scheme. That provides a reliable source of income from the generation of electricity and is regarded as not involving a higher-risk investment worthy of EIS or BASIS relief.

EIS/BASIS possible tax mitigation schemes

1. **Protection through lower-risk strategy:**

   Octopus Investments has an approved EIS fund known as the Octopus Protected Enterprise Investment Scheme. Main features are:

   - 3 year scheme, with opportunity to dispose of investments and reinvest then (N.B. anti-avoidance prevents EIS relief if there is a guaranteed exit route after 3 years, as opposed to a planned exit route).
   - Lower-risk strategy planned, involving investment in sectors where they consider a high degree of predictability exists.
   - The only real protection, however, is the waiving of the normal annual management fee of 2% if the net asset value at the end of year 3 is less that at the start.
   - Minimum investment £50,000.
   - Initial charge 5%.

2. **Combining tax reliefs as under:**

   a. on 1/5/11 Jan, a 40% taxpayer, invests £10,000 into an EIS company or EIS fund

   b. on 1/5/14 she contributes £10,000 gross into her pension plan

   c. on 2/5/14 the pension plan buys the EIS investment from Jan at market value (say £10,000, the same as the original cost)

   <u>effective costs:</u>

   a. £7,000 net of 30% tax relief

   b. £6,000 net of 40% tax relief

   c. return of £10,000

   Jan has therefore effectively paid £3,000 for a £10,000 EIS investment, which means tax relief at 70%.

3. Applying above to BASIS:

If BASIS relief is at a fixed rate of 50% (as has been mooted, but the consultation document is silent on this aspect) then Jan would get tax relief at 90% (100% if a 50% taxpayer).

4. BASIS investment worth the same after 3 years:

BASIS investment of £10,000. Tax relief @ say 50% = £5,000. Net cost £5,000.

After year 3 or later the shares are still worth £10,000 and tax relief cannot be clawed-back. IHT BPR after year 2 @ 40% = £4,000, so net cost becomes £1,000 for an investment worth £10,000.

5. BASIS investment becomes worthless

BASIS investment of £10,000. Tax relief @ say 50% = £5,000. Net cost £5,000.

In year 3 or later the shares become worthless. Income tax loss relief on £5,000 @ 50% = £2,500 so net cost becomes £2,500. It could be said that there is also an IHT reduction of 40% of the net cost of £2,500, but that could be argued for any investment which became worthless.

Contributed by Gerry Hart

Capital Taxes

Apportioning gain on sale of property

The taxpayer submitted a self assessment tax return, showing employment income, rental income and a capital gain on her share of the sale of a property.

After an enquiry into the return, HMRC concluded the taxpayer was assessable on the whole gain, on the basis she was the sole legal and beneficial owner of the property.

The taxpayer appealed.

She said the mortgage on the property, which had been bought for her daughter to live in while at university, was in her name only, but her husband shared the payments. They decided to sell the property, and reinvested in another one. They also owned their family home.

The First-tier Tribunal agreed that, at face value, the property in question was legally and beneficially owned by the taxpayer.

However, it was clear from the evidence that it had been bought in part with savings made by her and her husband. In fact, the proceeds of an endowment policy held solely in the husband's name had also been used to fund the purchase.

The tribunal accepted the taxpayer and her husband were both beneficial owners of the property, and the gain on its sale should be apportioned between them.

The taxpayer's appeal was allowed.

Y Lawson (TC1206)

Administration

PAYE returns online – reasonable excuse

The taxpayer, a small village rugby club with a single employee, submitted its PAYE end-of-year returns by post and had an unblemished compliance record. In April 2010, the club was told it had to submit its 2009/10 return online.

The individual who completed the returns, Mr H, did not own a computer, and so asked a third party to help.

He found out he needed a user identification; the time it would take to obtain one would delay submission of the return, so he told HMRC. They replied that a delay would be all right provided it was not 'going into months over'.

Mr H completed the return on 26 May 2010 and printed a copy, but forgot to press the submit button. The tax was paid by 24 May.

The Revenue issued a penalty notification for not filing the return in September, charging a total penalty of £400: £100 for each calendar month the return was outstanding. Mr H appealed, claiming he had filed the return.

Subsequently, HMRC sent him a letter saying it appeared he had not pressed the submit button, and told him to submit online immediately, which he did. In the meantime, further monthly penalties accrued.

The taxpayer appealed to the First-tier Tribunal, claiming reasonable excuse.

The tribunal judge, Anne Redston, said she had to consider whether Mr H had 'acted in the way someone who "seriously intends to honour their tax liabilities and obligations would act"'.

She noted Mr H did not own a computer and sought help, as suggested by HMRC. It was, furthermore, his first experience of filing online; the tribunal judge found he had acted to the best of his ability.

The absence of an acceptance message that the return had been accepted was 'key information', but Ms Redston said there was no evidence that this fact was included in employer bulletins or other alerts used by the taxman, to remind small employers about the obligation to file online.

She concluded that, although 'being computer illiterate' was not on its own a reasonable excuse, Mr H's lack of experience of technology should be taken into account. The judge concluded the taxpayer had reasonable excuse for not filing online.

The taxpayer's appeal was allowed.

Pontyberem Rugby Football Club (TC1358)

The GAR – to be or not to be? **(Lecture P679 – 7.02 minutes)**

The idea of a General Anti- avoidance Rule (GAAR) was first considered back in 1998 as more and more schemes were brought onto the market to exploit apparent 'loopholes' in the UK legislation. The idea was to introduce a rule that would prevent aggressive artificial avoidance schemes without affecting genuine commercial transactions taking place.

The idea is currently being reconsidered by a working party whose findings are due to be published at the end of October this year. The Party is considering whether a GAR is viable, whether the UK needs one and assuming that we do, how we go about bringing one in.

So far, it seems that the Party think that a GAR could provide a solution to some of the current tax legislation difficulties but that it is not going to be easy to come up with wording. It is this wording that they are working on over the summer.

The plan is that by the end of October, the Party will publish a report of their findings and that, if it has been decided to go ahead, we should have legislation in draft form by the end of 2012 which will appear in the Finance Bill 2012.

Discovery developments **(Lecture P680 – 11.12 minutes)**

Basic position

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

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

- The loss of tax is the result of fraudulent or negligent conduct by the taxpayer or agent – Section 29 (4) TMA1970; or
- The officer of the Board could not have been reasonably expected to have identified the circumstances giving rise to the loss of tax before (a) the end of the normal enquiry deadline, or (b) before the conclusion of any enquiry, on the basis of the information that had then been made available to him – Section 29(5)

It has long been thought that this loads the dice very much in favour of HMRC, especially when looking at the definition in Section 29(6) of information being made available to an officer as under:

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

b) it is contained in any claim made for the year, or in any accounts, statements or documents accompanying the claim

c) it is contained in any documents, accounts or particulars which, for the purposes of any enquiries into the return or any such claim by an officer of the Board, are produced or furnished by the taxpayer to the officer whether in pursuance of a Section 19A notice or otherwise; or

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

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

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

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

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

Obtaining certainty on behalf of your client thus became very difficult as an assessment has to be made of exactly what should be disclosed to avoid a discovery being made in the future. Where the matter involves the valuation of an asset, use of the post-transaction valuation check procedure via form CG34 can only be recommended except in special circumstances. If this is not the matter of concern, full disclosure must be made in such detail that the result may well be the opening of an enquiry within the normal window.

HMRC's guidance

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

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

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

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

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

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

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

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

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

Mrs Lavinia Frances Corbally-Stourton v HMRC SpC692

The Special Commissioner included this in his judgment:

"In my judgment for the reasons which follow, the test in the tailpiece of Section 29(5) – the reasonable expectation of the awareness of the situation in subsection (1) – is to be interpreted thus: that the officer could not reasonably have been expected, on the basis of the information mentioned, to have discovered an insufficiency: i.e. to have come to the conclusion that it was probable that there was an insufficiency. I come to that conclusion because the language of the section in referring

to the 'situation mentioned in subsection (i)' incorporates by reference the idea of a discovery and therefore the concept of a conclusion that it was more probable than not that there was an insufficiency. Thus in my view it is not required that the officer be aware that there was in truth an insufficiency or that he be aware that it was beyond all reasonable doubt that there was an insufficiency, but merely that that information should enable him to conclude on balance that there was an insufficiency. Again a mere suspicion would not be enough, but, a conclusion in relation to which he had some residual doubt may well be sufficient. If he could reasonably have been expected to have come to such a conclusion before the later of the times mentioned he is precluded from making a discovery assessment".

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

Discovery issues from *Bird v HMRC SpC720*

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

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

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

Dr Michael Charlton and Others v HMRC TC1317

The taxpayer won this case, although HMRC may well appeal in view of its wide application. Since the decision was published there have been instances of tax advisers stating that in similar circumstances HMRC agreed to back down and withdraw their attempt to make a discovery.

In this particular case several clients of an accountancy firm had participated in a tax avoidance scheme. Whilst HMRC commenced an enquiry in most cases, in three cases they had failed to do so within the window and unsuccessfully argued that they could make a discovery.

The main factors were:

1. All three of the individuals had made detailed disclosures in their tax returns about the scheme and had stated the DOTS scheme reference number.

2. HMRC argued that whilst the returns included factual details of the scheme they did not flag up that there was an actual insufficiency in the return, and following the ***Veltema*** case that was necessary to prevent a discovery.

3. The reason HMRC failed to start an enquiry within the normal deadline was not because an Inspector looked at the returns and missed the relevant points, but instead it was down to admitted administrative slip-ups such that nobody of the appropriate seniority looked at the three tax returns.

4. In the simple case the notional average officer should take his own decision on whether to assess. In a manifestly obvious tax avoidance scheme that has already been disclosed to HMRC and reviewed by them, one just considers what the notional average officer should and would have done in the relevant circumstances. This approach deals with matters in the appropriate way and it avoids the consequences of HMRC's contention that the test in Section 29(5) is crafted essentially for the simple scheme and does not apply where a tax avoidance scheme is involved.
5. The tribunal added that whether the test they came up with by reference to Section 29(5) creates the right balance of fairness between HMRC and taxpayer is entirely secondary. However they also said that if they had adopted the contentions and conclusions advanced by HMRC *"we cannot resist observing that a quite extraordinary imbalance would have been achieved between the taxpayer and HMRC"*.

Contributed by Gerry Hart

Avoidance scheme and failed discovery assessments

In 2005/06 and 2006/07, the three taxpayers entered into a Tenon-promoted tax avoidance scheme that, in essence, created artificial losses by means of the purchase and surrender of an existing life assurance policy.

On their self assessment returns, the taxpayers claimed the losses against capital gains. In the white space of the returns, they included sufficient details of the insurance policy transactions.

The returns also indicated that the taxpayers had taken part in a scheme that had required prior disclosure to HMRC under the disclosure of tax avoidance schemes rules. The scheme was subsequently found to be ineffective.

The Revenue failed to open enquiries into the taxpayers' returns in the specified period, so the department instead made discovery assessments in respect of the gains.

The taxpayers appealed.

The First-tier Tribunal delivered a lengthy decision, the final outcome of which was that the discovery assessments were not valid. The judge said the taxpayers had disclosed sufficient information in their returns and 'no officer could have missed the point that an artificial tax avoidance scheme had been implemented'.

It seemed 'perfectly obvious' that no officer had 'even looked at the returns' in time to raise an enquiry. Had an officer done so, he or she would have seen that such a scheme had been entered into, and been able to obtain guidance from colleagues as to how to proceed.

Immediate assessments would have followed made within the appropriate time. This did not occur and, in the circumstances, although the Revenue had made a discovery within TMA 1970, s 29(1), the taxpayers were protected from discovery assessments by TMA 1970, s 29(5), because they had provided adequate information to allow the assessments to have been made in the proper time.

The taxpayers' appeals were allowed.

Dr M Charlton, Mrs B Corfield, J Corfield (TC1317)

Responsibility to notify change of circumstances

The taxpayer did not receive his 2008/09 tax return on 6 April 2009, as a result of which he was unable to file his paper return by 31 October 2009, he claimed.

He had been completing self-assessment tax returns in respect of expense claims since 2001/02 and was therefore fully versant with his obligations.

HMRC's records showed post to the taxpayer had been returned undelivered in January 2009 and he had failed to advise the department of his correct address until 15 December 2009.

He was subsequently issued with a notice to file a return for 2008/09 in February 2010.

The taxpayer finally submitted the return in June, leaving the Revenue to carry out the calculation, which resulted in an underpayment that the department said had to be settled by direct payment because it was too late to code it out.

The taxpayer did not agree that HMRC sent him the 2008/09 return in February 2010, although he admitted the return was submitted in early June.

With regard to his changed address, he said the Revenue should have known his new address via his employer, but regardless of that he should have received a return at the right time from the taxman because he had set up a postal redirection service in October 2008.

He claimed a reasonable excuse for late payment of tax because the arrears of tax had resulted from HMRC's failure to make proper and timely use of information either supplied or available to them.

The First-tier Tribunal concluded it was the taxpayer's responsibility to notify HMRC of changes. The tax that was charged for 2008/09 was statutorily due and could not be collected through the taxpayer's PAYE code for 2010/11.

The taxpayer's appeal was dismissed.

Michael Mackey (TC1347)

HMRC extends Business Records Checks

HM Revenue & Customs (HMRC) has announced an extension of its Business Records Checks programme.

Business Records Checks were piloted earlier this year in eight key areas, and involve checks on the adequacy of small and medium-sized enterprises' business records.

The pilots found that around 44 per cent of businesses visited had issues with their record-keeping, while around 12 per cent of those visited had seriously inadequate records.

HMRC will be now be extending this activity from mid-September to cover a number of key areas across the UK. As part of this, the number of full-time staff employed on the programme will rise from 30 to 120.

HMRC plans to complete up to 12,000 Business Records Checks by the end of the current financial year, with 20,000 provisionally planned for 2012/13. HMRC is increasing the number of visits, so it can refine the process, before final decisions on a national roll-out are taken in the New Year.

Initially, HMRC will only levy a record-keeping penalty in the most extreme cases of poor record-keeping. In the longer-term, HMRC intends to issue penalties of up to £3,000 for serious inadequacies in record-keeping. HMRC will issue guidance on this, and make a further announcement on when it will happen, in due course.

NAT 76/11

CIOT: Questions remain over business record checks

A number of serious questions remain unanswered over HM Revenue & Customs' (HMRC's) Business Records Checks programme, says the Chartered Institute of Taxation (CIOT). The CIOT has commented following the announcement by HMRC of an extension of the programme.

CIOT President Anthony Thomas said:

"The CIOT is strongly supportive of efforts to improve record keeping by business.

However we continue to have serious concerns about a number of aspects of HMRC's programme.

"During the consultation process we queried the legal basis of applying penalties before a tax return has been submitted. These questions remain. HMRC have still not provided any satisfactorily clear reasoning to justify their belief that they can change penalties in-year before the return goes in. In our view it is questionable whether HMRC have the power to do that.

"We continue to be concerned about how HMRC judge whether records are adequate – there have been some clear misunderstandings within HMRC as to what constitutes 'adequate' records as opposed to 'incomplete' records. For example, despite HMRC's Powers team indicating that, in-year, a 'full shoebox of invoices/receipts' was adequate, we now understand that the new compliance team considers that retaining a set of purchase invoices without listing them is inadequate, even for the smallest businesses.

"In our view that is entirely the wrong approach. What counts as adequate records needs to have regard to the sort and size of business. That involves the exercise of judgement. Expecting the smallest businesses to have perfect records kept up to date every day is frankly unrealistic, inappropriate and wholly out of kilter with the Government's stated aim of reducing burdens on business.

"The CIOT is also unhappy about HMRC's handling of the process of expanding this programme. They have begun rolling out the programme before providing evidence that the trials conducted earlier this year have been cost-effective. Additionally HMRC had already started rolling out the expanded programme well before today's announcement – communications seem very much an afterthought. That is not the way to build a good relationship with tax advisers.

"This matters, because tax advisers are an essential part of the solution in this area. Advisers understand HMRC's frustrations about businesses that keep poor records. We are keen to work with HMRC to arrive at an appropriate and sensible approach, so that we can educate business about good practice and support them in improving their systems. But HMRC's approach in this area seems to be a blunt instrument designed with little or no input from professional bodies, and their approach has given many the impression that their objective is more about revenue raising – through the application of substantial fines – than spreading best practice."

Quasi-Legal General, 22/09/2011

New CIS penalty regime set to take effect

Changes to penalties for late construction industry scheme (CIS) returns will come into effect from 6 October. They include:

- £100 fixed fine if the return misses its due date of the 19th of each month;
- second £200 fixed penalty if a return is two months late;
- tax-geared penalty if the return is not filed six months after its due date, i.e. the greater of 5% of any deductions shown on the return or £300;
- second tax-geared fine if the return is still outstanding after 12 months. This will be the greater of 100% of any deductions or £3,000 if withholding of information was deliberate and concealed; the greater of 70% or £1,500 if it was deliberate but not concealed; and the greater of 5% or £300 for cases in which information was not withheld;

- upper limit on the amount of fixed penalties charged to new contractors that have not filed their first returns on time; and
- interest on any fine paid late.

The first return affected will be for payments made to subcontractors in the month ending 5 November, which is due on 19 November.

Revenue reminder on new tax return penalties

HMRC has issued a reminder about new self-assessment penalties for late returns and late payments, which come into effect this Autumn.

HM Revenue & Customs (HMRC) is reminding individuals and businesses about new Self Assessment penalties for late returns and late payments, which come into effect this autumn.

The changes will affect Self Assessment returns for 2010/11, and all future financial years.

The new penalties for late Self Assessment returns are—

- an initial £100 fixed penalty, which will now apply even if there is no tax to pay, or if the tax due is paid on time;
- after 3 months, additional daily penalties of £10 per day, up to a maximum of £900;
- after 6 months, a further penalty of 5% of the tax due or £300, whichever is greater; and
- after 12 months, another 5% or £300 charge, whichever is greater. In serious cases, the penalty after 12 months can be up to 100% of the tax due.

New penalties for paying late are 5% of the tax unpaid at—

- 30 days;
- 6 months; and
- 12 months.

Interest will also be charged on top of these penalties.

The tax return deadlines remain unchanged – 31 October for paper and 31 January for online returns. The deadline for paying any tax due also remains the same at 31 January.

Business Taxes

Consultation: Fixtures in buildings (Lecture B676 – 13.46 minutes)

On 31 May 2011, HMRC published a consultation paper proposing changes to the capital allowances regime on fixtures in buildings. The consultation period closed on 31 August 2011.

There are four main proposals:

1. imposing a time limit on when expenditure on plant and machinery is required to be claimed;
2. restricting the minimum transfer value a purchaser and vendor can adopt for a CAA 2001, s 198 election to the tax written down value (TWDV) of the asset;
3. requiring the purchaser and vendor to decide a single agreed value verifying the amount of the sale price attributable to the fixtures, which both parties should record and formally notify to HMRC within one or possibly two years; and
4. tightening the anti-avoidance rules within CAA 2001, s 197, to prevent the increase of capital allowances claims on fixtures by artificial arrangements.

Claiming allowances

Currently, expenditure on fixtures in a building can be claimed at any time for any open tax return, as long as the fixture is still owned by the taxpayer.

These rules have proven valuable to those taxpayers who have purchased commercial property, but who have not fully assessed or optimised the capital allowances available on the fixtures in the property until after the purchase. It can be problematic to trace the tax treatment of the previous owners with respect to what, if any, allowances were claimed by them or the vendor, and what proportion of the purchaser's costs may have already benefited from tax relief.

These issues have been considered recently by the First-tier Tribunal in the case *Mr & Mrs Tapsell & Mr Lester (as partnership The Granleys) v HMRC* [2011] UKFTT 376. The tribunal held that the burden of proof lies with the claimant to demonstrate that there were no previous capital allowances claims or, if so, the prior disposal value.

Irrespective of the proposed changes, it is important to establish the correct position in regard to fixtures and to ensure capital allowances form an integral part of the due diligence when advising property owners on their purchase transactions.

Time limit proposal

The consultation is seeking views on the proposed time limit, initially suggesting one year or possibly two years after purchase. The purchaser will need to inform HMRC of their expenditure on fixtures within the required time limit or risk losing the ability to claim capital allowances forever. This would mean future owners no longer having the right to claim either.

Key concern

Major construction projects can span several years and such a short timeframe for claiming may deny taxpayers the correct tax relief, as figures may not be properly ascertainable if all of the project costs have not been finalised.

CAA 2001, s 198 election

This election allows purchasers and vendors to agree a fixed apportionment of expenditure within the full purchase price to be attributed to these assets.

Currently, the elected value can be any figure from £1 up to the value of the eligible assets as previously claimed by the vendor, or the price paid by the purchaser, whichever is the lower.

The £1 election is useful for vendors where it may be problematic to ascertain the TWDV of specific assets in specific properties, or when the purchaser may not benefit from tax relief because they are non-taxpayers, such as a pension fund or a developer seeking to redevelop a site that doesn't incur capital.

When a s 198 election is suggested, it should be assessed to determine whether the suggested level of allowances is 'fair and reasonable' and explore any other tax implications for the parties involved.

Minimum price proposal

The consultation document proposes that the minimum amount that may be fixed as the price incurred on the provision of the fixture should be the TWDV of the fixture in the hands of the vendor.

The change in the minimum amount for a s 198 election is likely to prove unpopular with purchasers and vendors as it will deny the parties the ability to allocate the allowances to the party to whom they are most valuable, which could affect the pricing of deals in future.

Record of agreement

The vendor and purchaser will need to agree the part of the sale price attributable to the fixtures and to submit a joint record of their mutual agreement to HMRC with their respective tax returns.

It has been suggested that the timescale for this record of agreement should be similar to the mandatory pooling requirement: within one or possibly two years.

This record creates a greater administrative burden on the taxpayer, but also increases complexity at the due diligence stage prior to exchange of contracts. This will result in greater transaction fees and potentially slow average transaction times.

Tightening the anti-avoidance rule

The anti-avoidance rule in CAA 2001, s 197 applies where the actual disposal value of any plant and machinery is less than its TWDV and a disposal event occurs as a result of an arrangement where the main purpose is for the taxpayer to obtain a tax advantage.

Section 197 enables HMRC to substitute the disposal value for a 'notional tax-written down value'. The government believes s 197 may not always be effective in preventing tax avoidance – or is this again a case of HMRC not applying the existing legislation and case law effectively?

The consultation paper proposes to make it clearer that these provisions will be activated in all instances where an artificial tax arrangement is used to result in capital allowances on the fixtures being accelerated by a balancing allowances and the taxpayer obtaining an unfair tax advantage.

However, HMRC admit that if the s 198 proposals are accepted, future elections will not be validly made at a value lower than the vendor's TWDV, and the proposed changes to the s 197 anti-avoidance rules may not be required.

Based on an article by Alun Oliver and James Daniels writing in Taxation

Capital allowances and boat leasing

The taxpayer began a boat chartering business in 2001. A year later, he decided to relocate the firm to Spain, which he believed would offer better opportunities. He operated remotely, leasing boats through an agency.

He included capital allowances in respect of a boat used in the chartering business for the years ended 5 April 2003, 2004, 2005 and 2006, and used them to offset losses against other income, under TA 1988, s 380, for the respective years.

HMRC disputed the claim on the basis the taxpayer was in the business of bare boat leasing. Furthermore, the taxpayer had a full-time job, and the boat business was not his main occupation. The capital allowances should therefore be restricted.

The taxpayer appealed.

Looking at TA 1988, s 384, which restricts the set-off of a loss against other income, the First-tier Tribunal looked first at the nature of the trade.The judge believed a boat chartering trade was being operated, but that while there was one trade, the losses had arisen from two different activities.

These were a non-leasing activity where the boat was hired out with a skipper, and a leasing activity: the bare boat business.

On the evidence, it was clear the taxpayer was actively engaged in the business, but it was also true that he was a full-time employee elsewhere. On balance, however, the tribunal concluded the taxpayer did carry on only one trade, that of chartering boats.

As to the restriction of the set-off of losses, they should be apportioned. When the boat was hired out with a skipper, it was provided otherwise than ‘in the leasing in the course of a trade’. Therefore, the proportion of losses relating to that, including the capital allowances, could be allowed.

When the boat was hired out without the skipper on a bare boat charter, it was provided ‘for leasing in the course of a trade’, and the losses, other than the capital allowances, could be offset under s 380.

It was agreed the taxpayer would give HMRC details of the percentage of skippered and non-skippered charters, from which the two parties could agree the losses for set-off.

Finally, the taxpayer had appealed against discovery assessments, which the tribunal accepted had been correctly made: the information provided by the taxpayer in the relevant assessments had been insufficient.

The taxpayer’s appeal was allowed in part.

G B Forbes (TC1278)

Construction Industry Scheme: Gross payment status or not?

The taxpayer, Croftport Ltd, was a well-established property developer with two directors and one employee. When carrying out a development, it would engage up to 12 subcontractors.

On a particular project, the company employed T&S, which told the director of Croftport that it had gross payment status under the construction industry scheme (CIS). The subcontractor produced evidence of its status, and Croftport’s payments to the firm were made without deduction of tax.

HMRC opened an enquiry because they had no record of T&S having gross payment status. The department told Croftport it should have deducted tax from the payments to the subcontractor, and imposed a penalty for failure to do so.

The company appealed.

The First-tier Tribunal accepted the Croftport director had seen what he believed to be evidence that T&S had gross payment status. The judge noted the subcontractor had begun work for Croftport before the construction industry scheme came into effect.

However, the first payment made was after April 2007.

For that reason, Croftport should have first confirmed with the Revenue the status of T&S (Income Tax (CIS) Regulations 2005, reg 6(4)).

The question for the tribunal to decide was whether the taxpayer had taken reasonable care to comply with regulations.

The tribunal referred to an HMRC news release dated 10 November 2006, which publicised the new CIS, noting in particular the statement, ‘Whenever a contractor takes on a new subcontractor or one that has not worked for them in the current or previous two tax years, they will need to contact HMRC to find out how they should be paid’.

The judge decided this implied that where a contractor took on a subcontractor it had previously employed in the current tax year or the previous two, it would not be necessary to contact the taxman about the subcontractor’s gross payment status.

T&S had been employed by Croftport in the previous year, and the director had reasonable grounds for believing the subcontractor had gross payment status.

The statement in the news release gave credence to the director's understanding that there was no need to contact HMRC for the purposes of the CIS.

On this basis, the tribunal ruled Croftport had taken reasonable care to comply with regulations 2005; its failure to deduct the tax was due to an error made in good faith.

The taxpayer's appeal was allowed.

Croftport Ltd (TC1272)

Corporate planning for the future (Lecture B677 – 12.53 minutes)

Currently we have high personal rates and falling corporate tax rates which makes it important to consider what structure is most appropriate for clients going into the future, particularly where they are involved with more than one enterprise and in more than one location. So typically hoteliers, dentists and farmers

Traditionally

Where a company leaves a group, taking with it an asset previously transferred on a no gain no loss basis in the group within the last 6 years, a degrouping charge arises. This charge arises on the company leaving the group and so effectively becomes an issue for the purchasing company. However, it was common practice for the holding company to agree to take the degrouping charge back into their group where they could possibly roll it over or do other planning.

Things changed in the Finance Act 2011. The degrouping charge is now added to the disposal consideration but with the Substantial Shareholding Exemption being available, the degrouping charge is now exempt from tax.

Associated companies

One of the problems of having a number of subsidiaries is that they may well be taxed at the marginal rate of tax. However, the plans are for the main rate of corporation tax to fall in the next few years so alleviating this problem somewhat. By the Financial year 2014 it is proposed that the main rate of tax will have fallen to 23% and the resultant marginal rate will have fallen to 23.75%.

What could this mean for group structures?

Let's assume that our client buys hotesl on the South coast when they go bust. He converts each into a bijou weekend location for bankers with the intention of selling the hotels on when they are running successfully. How should he structure these transactions?

Traditionally all hotels would have been kept in one company to manage the small companies rate and keep the due diligence simple but this would trigger 26% corporation tax on the gain in the singleton company.

Now

Our client could consider owning a dormant holding company with each hotel business bought being held in a separate subsidiary. All property would initially be held in the holding company for protection in case the hotel goes bust and then just before the subsidiary is sold, the hotel would be transferred down to the subsidiary.

Any gain on disposal should be covered by the Substantial Share Holding Exemption with no corporation payable.

So we now have an efficient group structure for selling and on retirement. Provided that we have a trading company/trading group throughout, our client's assets are protected while he is working, the Substantial Share Holding Exemption is available when individual elements are sold during his working life and then on retirement, entrepreneurs' relief, business property relief and agricultural property relief should be available on the shares when needed.

Based on an article by Bob Trunchion

Loan relationships: the write off of corporate debt (Lecture B678 – 12.55 minutes)

The rules for the taxation of a company's "loan relationships" ("LR") were introduced with effect from 1 April 1996 and are now contained in CTA 2009 s292 onwards.

A company has a loan relationship if it stands in the position of a creditor or debtor as respects any money debt which arises from a transaction for the leading of money. Trading transactions involving goods and services are excluded but the release of trade debts between connected companies, following changes introduced in FA 2009 fully fall within the LR rules for both creditor (lending company) and debtor companies (borrowing company). This is covered further below.

The LR rules simplify the tax treatment of profits and losses made on loans as these are based on amounts arrived at using generally accepted accounting practice. The amounts reflected in the accounts are treated as income or expenses or in the case of debt releases impairment losses.

Release / write off of debts

Where one company, (creditor co) releases a debt owed by another unconnected company (debtor co), the amount released would be treated as an expense, (impairment loss), for the creditor company and as income in the books of the debtor company. The creditor company may choose not to release the debt but simply provide for it as a bad debt in which case it would be entitled to an impairment loss. The debtor company would not be affected by this provision.

Matters become more complex when companies are connected. The basic rule in relation to the write off of loans between such companies is that there is no impairment loss for the creditor company (assuming it is liable to UK corporation tax) (S354). Conversely under s358, there is no tax charge on the debtor company. In effect the transaction is tax neutral. Such a result now applies to the release of trade debts after 22 April 2009. Prior to the change, whilst the creditor company was denied a deduction the debtor company was taxed on the release. The changes have now corrected this asymmetrical position.

Exceptions to the basic rules on release of debts

Swapping debt for equity (s356) - where the creditor accepts shares in the debtor company as full and final settlement of the debt, releasing any amounts in excess of the value of shares, an impairment loss can be claimed if:

(i) The creditor treats the liability as discharged;
(ii) It does so in exchange for ordinary shares;
(iii) The creditor company was not connected to the debtor company prior to the equity swap.

The debtor company position would be dependent on the connection with the creditor company at the time of the release.

Where the creditor is insolvent (s357) – an impairment loss can be claimed for any released debts arising after the date insolvency proceedings have commenced , on the condition, the creditor company is in insolvent liquidation or provisional liquidation, insolvent administration, insolvent administration receivership or equivalent circumstances under the law of a territory outside the UK.

Where the conditions apply, the debtor company would not be taxed on any debt released as long as the two companies were connected before the date the creditor entered into insolvency proceedings and were no longer connected immediately after such time.

Debtor becomes insolvent

Where connection between companies is not broken by the debtor company's insolvency, the normal rule under s358 applies. However, if the insolvency breaks the connection, s322 ensures that a release by the creditor company is not taxable on the debtor company.

Connected companies

Companies are connected under LR rules if one controls the other or they are both under common control, so companies in the same group are connected (s466). Control for these purposes is different than that applied for associated company purposes and is defined in s472.

Control for LR purposes means the power of a person to secure that the affairs of the company are conducted in accordance with the person's wishes –

(a) By means of the holding of shares or the possession of voting power in or in relation to the company or any other company, or

(b) As a result of any powers conferred by the articles of association or other document regulating the company or any other company.

The legislation refers to "person" in the singular so this raises an issue when considering the connection between two companies owned 50/50 by the same two individuals. While not free from doubt, the view taken by most practitioners is that in such circumstances, unless the individuals are acting in concert, making joint decisions on how to manage and control each company, they will not be connected for LR purposes. Others highlight the case of Floor v Davis (1979) STC 379, which expressed the view that unless anything is expressed to the contrary, words in the singular include the plural and visa versa. Care therefore needs to be taken in such cases.

Contributed by Martin Mann, Gabelle LLP

Had money been loaned?

The taxpayer company, MJP Media, was a wholly-owned subsidiary of Carat International, which itself was wholly owned by Aegis plc. Between 2001 and 2004, various inter-company transactions took place between MJP and Aegis.

The result was that by 1 January 2004, Aegis owed MJP more than £6.8 million. Between that date and 26 March 2004, the parties signed a document agreeing MJP had loaned Aegis the sum in question. On 26 March, the parties signed another agreement in which MJP waived £6.7 million.

In its 2004 corporation tax computation, MJP claimed the amount as a deduction. HMRC refused the claim.

The company appealed, claiming the transaction fell within the loan relationship rules in FA 1996, s 81 (now CTA 2009, s 302). The First-tier Tribunal found for HMRC, so the company appealed to the Upper Tribunal (Tax and Chancery Chamber).

The Upper Tribunal noted the First-tier Tribunal had dismissed the appeal because of the lack of evidence provided by MJP to show that it had lent money to Aegis.

There were insufficient bank statements to support the contention, and none of the witnesses had firsthand knowledge of the transactions.

The Upper Tribunal agreed with the First-tier Tribunal that the burden of proof lay with the taxpayer when claiming a deduction, and this could have been satisfied by the production of all the relevant bank statements. However, the company had not retained them.

The taxpayer's appeal was dismissed.

MJP Media Services Ltd v CRC, Upper Tribunal (Tax and Chancery Chamber)

Deductibility of interest on loan from Dutch parent by German subsidiary

The applicant company was a limited liability company incorporated under German law. It was wholly owned by a limited liability company established in the Netherlands. Between August 2003 and December 2004, the applicant obtained loans from its parent company. For those loans, the applicant paid its parent company interest (the interest) in 2004. That amount was deducted by the applicant from its profits as operating expenditure. In its decision assessing the basis of calculation of business tax for 2004 the German tax authorities found, however, that the applicant was entitled to deduct from its profits only 50% of the interest, so that half of the interest was added to the applicant's business profits. The applicant brought proceedings against the respondent's decision on the basis that the addition of half of the interest constituted taxation contrary to art 1(1) of Council Directive 2003/49/EC (on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states). The German court stayed the proceedings and referred a question to the Court of Justice for a preliminary ruling.

The question was whether art 1(1) of Council Directive 2003/49/EC precluded a provision of national tax law under which loan interest paid by a company established in one member state to an associated company in another member state was incorporated into the basis of assessment of the business tax payable by the former company.

The Court ruled that art 1(1) of Council Directive 2003/49/EC had to be interpreted as not precluding a provision of national tax law under which loan interest paid by a company established in one member state to an associated company in another member state was incorporated into the basis of assessment of the business tax payable by the former company.

Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Sud C-397/09

Latest issues relating to research and development **(Lecture B679 – 18.00 minutes)**

Finance Act 2011

For expenditure incurred from 1 April 2011, small and medium sized companies will be able to claim 200% relief on qualifying expenditure. It is proposed that this will increase to 225% from April 2012.

R&D tax credit

From 1 April 2011, the repayable credit has fallen to 12.5%, previously 14%. So for every £100 spent on qualifying R&D, the company can deduct £200 in arriving at their taxable profit. To the extent that this creates or augments a loss, the company will be able to sell that loss to HMRC in return for a £25 cash payment.

Currently, this will only be payable if the company has paid PAYE/NIC for the tax months ending in the accounting period of the R&D claim. Where the repayment is likely to be capped, the company could consider bringing forward a proposed bonus payment so that it falls into the R&D period.

It is proposed that the PAYE/NIC cap will be removed from April 2012.

SME definition

A SME for R&D purposes can employ up to 500 employees and must either have turnover not exceeding €100m or gross assets not exceeding €86m. This is twice as generous as the normal accounting SME definition.

Eligible R&D expenditure

To be eligible expenditure, the company must be attempting to resolve some kind of scientific uncertainty but the company does not have to actually succeed. They must be looking to advance the global state of knowledge in an area. Once that knowledge is publically known, no further R&D relief may be claimed in that area.

R&D begins when work to resolve the scientific uncertainty starts and ends when that uncertainty is resolved or work ceases. It is important that this work is clearly documented.

The expenditure must be revenue in nature and relate to expenditure on qualifying staff, materials and consumables. Subcontractor costs also qualify for SMEs.

The company must spend a minimum of £10,000 in a 12 month period and from 1 August 2008 there is a lifetime limit for large projects whereby total qualifying expenditure cannot exceed €7.5m.

Qualifying expenditure does not extend to rent, rates, telephone, benefits in kind or share based remuneration.

100% first year allowances are available on buildings used for R&D but this cannot be rolled forward.

Qualifying staff

These are staff who are directly and actively involved in the R&D work by planning, organising and carrying out the work.

Where staff are not engaged full time in the R&D work, their costs need to be time apportioned which is where timesheets are invaluable. It is worth noticing that HMRC do not believe that anyone is employed 100% of the time on R&D work.

Be careful with self-employed R&D workers and those whose contracts are outside IR35. These do not qualify.

Contracted out R&D for SMEs

The work must involve some R&D rather than simply sub-contracting out some function of the R&D. So testing alone would not qualify but doing some R&D which is also tested by the sub-contractor should be fine.

Where the claimant and sub-contractor are connected then the R&D relief claim is the lower of:

- Cost incurred in sub-contractor's year end accounts; or
- Amount claimant paid the sub-contractor

Unconnected parties can claim on the connected party basis but it will require the sub-contractor to disclose their profit margin and then a joint election to eb made. If no such election is made, the SME may only claim 65% of the payment to the sub-contractor for their R&D work.

Grants and subsidies

If all or part of the project costs are met by grants or subsidies then none of the costs will qualify for R&D relief.

For State Aid grants that are notified but later refused or repaid, large company R&D relief is claimable.

Non State Aid grants do not jeopardise SME relief so that revenue expenditure that is not covered by the grant will attract SME relief.

Many grants relate to capital expenditure which clearly should not affect any R&D relief claim.

HMRC Toolkit—Small Profits Rate and Marginal Relief (2010/11)

HMRC's Sepember 2011 toolkit is aimed at helping and supporting tax agents and advisers by providing guidance on the errors that HMRC commonly find occur in relation to small profits rate and Marginal Relief. It may also be helpful to anyone who is completing a Company Tax Return.

Areas of risk within small profits rate and Marginal Relief

Small profits rate and Marginal Relief may be claimed incorrectly if the number of associated companies is not fully considered.

Risks broadly fall into three categories:

1. Record keeping

2. Incomplete information

3. Applying the correct rules

Checklist for small profits rate and Marginal Relief

1. Have you checked the notes to the accounts to consider whether there are any associated companies?
2. Have you checked whether there are any non-UK resident companies associated with the company?
3. Have you checked whether there are any other companies associated with the company?
4. Have you considered whether any of the shareholders or participators control another company by themselves or with others?
5. Have all appropriate attribution of rights and powers been considered?
6. Have you considered whether control of a company is other than by shares?
7. Have all minimum controlling combinations been considered in establishing the control of a company?
8. If you consider Extra Statutory Concession C9 applies have you reviewed the specific test within the concession?
9. If the company is a close company, have you considered whether the company is a close investment-holding company (CIC)?
10. Have you reviewed any dormant companies to check whether they are dormant for small profits rate or Marginal Relief purposes?
11. Has the correct rate of tax and Marginal Relief been applied?

Attribution of rights and powers

These are rights and powers of people or companies, which are added or attributed to another person or persons, in order to consider if that person or persons can control a company. You need to include the rights and powers of associates which include:

- husband and wife, civil partners
- children, grandchildren and younger linear descendants
- brothers and sisters
- business partners
- trustees of settlements - trustees are associates where the participator or any living or dead relative (brother, sister, ancestor or linear descendant) is or was the settlor
- for associates which are companies, the rights can also be attributed by virtue of control of another company

Aunts, uncles, cousins, nieces and nephews are not associates.

Separated spouses should be regarded as associated with each other but divorced persons should not. Other relatives should be regarded as associated only if there is a blood relationship - for example, half-brothers are associated but stepbrothers are not.

Remember these rules changed on 1 April 2011. From this date we need to consider if there is substantial commercial interdependence between businesses. If no substantial commercial interdependence exists between the businesses, a person is treated as having no associates.

Control other than by shares

Control of a company may be established by less obvious methods for example by loan creditors, voting power, rights on a winding up or rights to the greater part of the company's income.

In particular, a loan creditor is deemed to control a company, if they receive the biggest share of assets on the deemed winding up of the company.

Loan creditors do not include normal trade creditors, hire purchase creditors or a person carrying on a business of banking is not treated as a loan creditor in respect of any debt or loan capital incurred or issued by the company for money lent by the person to the company in the ordinary course of that business.

Example

A company has a balance sheet as follows—

Current assets - cash	£100,000
Current liability - loan creditor	£60,000
Net assets	£40,000

If the company was notionally wound up the £60,000 would be paid to its loan creditor and the balance split between the shareholders. In this scenario the loan creditor is in control of the company, as they receive the largest part of the assets on the notional winding up of the company.

Have all minimum controlling combinations been considered?

Two or more persons may control a company. If those two or more persons control another company then the two are associated, as they are under the control of the same minimum controlling combination. There can be more than one minimum controlling combination for each company, depending on the structure of the share ownership.

Example

In the following example all of the participators are unconnected.

Shareholders	*Company X*	*Company Y*	*Company Z*
Mr A	15%	33%	40%
Mr B	55%	33%	30%
Mr C	30%	33%	30%

Mr A + Mr B + Mr C, or Mr A + Mr B, or Mr B + Mr C acting together control company X, but Mr B can control it on his own. Mr B is the minimum controlling combination of company X.

Company Y and Z have three minimum controlling combinations

1. Mr A + Mr B
2. Mr A + Mr C
3. Mr B + Mr C

Company X is treated as having no associated companies. Companies Y and Z are associates.

ESC C9

Broadly this states that for the purposes of small profits rate the following may not be treated as associated, provided there is no past or present connection—

- companies controlled by a common loan creditor
- companies controlled by common fixed rate preference shareholders
- companies controlled by a common trustee, such as a trustee of a bank

In addition, where there is no substantial commercial interdependence between the companies, the attribution of a relative's rights and powers is limited to those of husbands, wives, civil partners and minor children. The shareholdings of other relatives are considered only if the companies under consideration are substantially interdependent.

For accounting periods ending on or after 1 April 2011, this no longer applies applies.

What is dormant?

A company can only be considered dormant if it did not carry out a trade or a business at any time during that accounting period.

Carrying out a business will normally include any period in which a company receives any income, including that from dividends or interest. If this is the case, then that company may not be dormant and may be considered an associated company.

There is one exception to this. A non-trading holding company is not associated, if throughout the period all of the following conditions apply—

- its only assets are shares in its 51% subsidiaries
- it is not entitled to a deduction, as charges or management expenses, for any outgoings
- it has no income or gains other than dividends
- all income is distributed in full to its shareholders

HMRC Toolkit 15 September 2011

Taxation of foreign branch profits

FA 2011 introduces an optional exemption from corporation tax for profits arising from foreign permanent establishments (PEs) of a UK company. If profits are exempt from corporation tax under these provisions, losses will be excluded to the extent that they arise from foreign PEs. Profits and losses will be treated in this way only when the company has made an election for these rules to apply to it. Once a company has made this election, foreign PE profits will be exempt and losses will be cancelled from the commencement of the next accounting period, subject to a transitional rule.

What is a PE?

A company has a PE when it trades in another state through a branch or other fixed place of business, or through an agent, other than an independent agent. The new rules allow the company to elect that the branch profits (and losses) be exempted from UK corporation tax.

How are exempt profits measured?

There are three ways to measure the profits that can be exempted (the ‘foreign PEs amount’):

- Where the branch is in a full treaty country, the exempted profits are those that would be attributable to the PE in a double tax relief claim under TIOPA

- Where the branch is in a full treaty country, but tax in that territory does not depend on the profits attributable to the PE, the exempted profits are those that would be attributable to the PE if tax in that territory did depend on the profits attributable to the PE. (Some full treaties provide for taxation by the foreign territory in respect of certain profits without any requirement that they are attributable to any permanent establishment in that territory. This provision ensures that the only profits specifically exempted from UK corporation tax are those that are attributable to a permanent establishment in the territory
- Otherwise, the exempted profits are those that would be attributable to the PE in a double tax relief claim under TIOPA if there were a full treaty with that country compliant with the OECD model

Losses are computed the same way.

Exclusions

Certain companies are wholly or partly excluded from the regime:

- The election cannot apply to a ‘small’ company unless the PE is in a full treaty jurisdiction.
- The election cannot apply to close company chargeable gains (which are imputed to UK resident shareholders).
- Insurance companies are excluded in respect of their basic life assurance and general annuity business.

Gains and losses on assets

Exempt profits will include gains on assets, whether as chargeable gains or taken into account in computing income. This specifically applies to gains in respect of immovable property used for the PE’s business. These gains would not otherwise be part of the foreign PEs amount.

There is also a need to make adjustments where the full gain or loss on an asset does not fall within the exemption (for example, an asset is acquired in the UK and only later transferred to the PE).

Capital allowances

Notional capital allowances for machinery and plant are to be computed and allowed as part of the calculation of exempt profits. The normal capital allowances rules are treated as applying to the PE as if it were a separate activity.

The impact of this measure will usually to be to reduce the exempted profits by the amount of capital allowances deemed to have been claimed.

Other provisions

The rules also require adjustment in a number of other areas:

- Certain payments to the PE by a UK resident person are excluded. These are where the payer would be required to deduct income tax from the payment if it were to a company. This does not apply if the company is a bank, as long as the payments are not part of a tax avoidance scheme
- Costs of employee share acquisitions are to be taken into account on a just and reasonable basis
- There is anti-avoidance legislation, designed to prevent the diversion of UK profits to low tax (<75% of UK rates) followed by a claim for exemption. This does not apply if:
    - the PE profits are less than £200,000
    - the tax reduction is minimal or
    - there was no tax avoidance motive.
- There is a mechanism to adjust for PE losses that occurred prior to the election. It is designed to prevent double relief for the losses by ‘matching’ the pre-election PE losses with post-election PE profits. Those profits are then not exempt, but presumably are extinguished by the losses, anyway, unless the losses have already been used. This provision

applies globally unless the company makes a streaming election for the losses of specific territories to be set against future profits of those same territories.

Effect

The legislation applies from the beginning of the next AP to that in which the election is made (or the day that AP was expected to start when the election was made), and then applies to all future APs. It cannot be revoked after the start of the AP in which it becomes effective.

The election also applies to all territories in which the company has (or will have) a PE.

Contributed by Pete Miller, The Miller Partnership

Value Added Tax

Further advice on VAT decision in Paymex Limited

HMRC provides further information for insolvency practitioners on refund claims arising from the First-tier Tribunal decision in Paymex Limited (TC01210). This follows the initial response in Brief 27/2011, which confirmed that HMRC would not be appealing against the decision.

VAT Tribunal decision in the case of Paymex Limited v HMRC

HM Revenue & Customs (HMRC) recently issued a Business Brief (Revenue & Customs Brief 27/11 - LNB News 20/07/2011 25) in response to the VAT Tribunal decision in the case of Paymex Limited v HMRC (TC01210), dealing with the VAT liability of services provided by an Insolvency Practitioner (IP) in an Individual Voluntary Arrangement (IVA).

Following on from the above mentioned Business Brief, HMRC wishes to offer further clarification on the following points which may be of interest or concern to the insolvency profession:

General

Although the Tribunal decision itself applied purely to consumer IVAs, HMRC considers that the terms of the Tribunal decision read across to all IVAs. The important point for IPs to consider here is not the specific type of IVA but rather whether the nature of the services they provide are covered by the terms of the Paymex Limited ruling.

Although HMRC does not consider the terms of the Tribunal decision to be restricted to a particular type of IVA, the Tribunal decision does not deal with Company Voluntary Arrangements (CVAs) or Partnership Voluntary Arrangements (PVAs). If IPs consider, on the basis of the Paymex Limited ruling, that they have overpaid VAT arising from their role as supervisors of CVAs or PVAs and seek to reclaim such VAT, these claims will be rejected.

Claims

The effect of the Tribunal ruling is that IPs may have overpaid VAT where their services in an IVA are covered by the terms of the ruling. IPs affected are therefore entitled, but not obliged, to claim a refund of wrongly declared output VAT, under Section 80 of the VAT Act 1994. However, IPs may also have reclaimed input VAT in such cases to which, following the Tribunal ruling, they may not have been entitled. Refunds will only be issued for the balance of output VAT wrongly declared on the services in question less any input VAT wrongly deducted on the assumption that the supplies to which it was attributable were taxable.

The input tax that will be deducted for the amount claimed will be both that input tax that was directly attributable to the supplies of services in question and, if the IP was already partially exempt, the appropriate percentage of the overhead or residual input VAT.

Public Notice VAT 700/45 How to correct VAT errors and make adjustments or claims explains how to go about claiming a refund in this circumstance.

If the IP was fully taxable for the period covered by the claim then making a claim for a refund of wrongly declared output VAT will have the effect of making them partially exempt for the period of the claim. In that event, they will have to calculate the percentage of overhead or residual input VAT that should have been blocked.

Although input tax must be taken account of by IPs when claiming refunds of overdeclared VAT as above, HMRC will not seek to recover input tax previously overclaimed in the light of this ruling in any cases other than those in which a claim for a refund of overdeclared VAT is made.

If the IP chooses not to "disturb the past", HMRC will not disturb it either. It is entirely a matter for the IP whether to claim a refund under Section 80 of the VAT Act or not. Nothing in VAT legislation obliges them to do so.

Time limits

Claims for a refund of overdeclared VAT are subject to normal capping rules. Claims for repayment will therefore not be considered for periods ending more than four years before the date on which the claim is made.

Any claim made under Section 80 of the VAT Act 1994 must set out the basis of the error and the amount being claimed and show how that amount has been calculated. The claimant must be able to provide copies of the documentation used in the calculation of the claim on request. An "estimated" claim, or a declared intention to lodge a claim at a future date, will not stop the clock running on the four year cap.

Unjust enrichment

HMRC can reject claims where they are able to show that the claimant would be unjustly enriched by payment of his claim.

If an IP decides to claim a refund under Section 80 of the VAT Act and reimburse his customers under Section 80A and Regulations 43A TO 43G of the VAT Regulation 1995, they must reimburse the total amount paid to them by HMRC in cash or by cheque. They are not entitled to deduct any amount by way of administration fee etc. This is expressly stipulated in Regulation 43C(b) of the VAT Regulations 1995, which states that "no deduction will be made from the relevant amount by way of fee or charge (howsoever expressed or effected)".

Once the refund is paid into the IVA estate in its entirety, the refund then becomes an asset of the estate. Any subsequent question of IP's costs will be determined by the terms of the actual arrangement in accordance with insolvency legislation.

Dividends

Where IPs intend to declare additional dividends to creditors in IVAs from money refunded by HMRC, HMRC's Voluntary Arrangements Service is happy to accept one collated payment covering all of the IVAs concerned if possible, provided the IP can still identify the proportion of that dividend for individual IVAs.

HMRC hopes the above information assists the insolvency profession by further clarifying HMRC's view of the impact of the Tribunal ruling in this case. IPs may request further advice on the correct VAT treatment in individual cases by contacting the VAT Helpline on Telephone number 0845 010 9000 begin_of_the_skype_highlighting 0845 010 9000 end_of_the_skype_highlighting.

Issued 20 September 2011

Nutritional advice

The taxpayer operated as a sole practitioner, providing nutritional advice to individuals and groups. She had no formal teaching qualification but held a diploma in nutrition.

She claimed her advice sessions were an exempt supply of private tuition for VAT purposes, so she did not therefore need to be registered for VAT.

Her view was her role involved educating people about what to eat, food preparation and understanding nutrition. Under the terms of her diploma she was not permitted to treat, diagnose or counsel in nutrition.

HMRC decided the taxpayer's business activities were consulting or advising; these could not fall within the definition of 'tuition' because there was no course, class or lesson of instruction involved.

The taxpayer appealed.

The issue before the First-tier Tribunal was whether or not the taxpayer provided private tuition in a subject ordinarily taught in a school or university.

It found there was a clear distinction between the activities of advising and practising nutrition as a therapist and teaching the subject to future professionals, The tribunal concluded the taxpayer was providing ‘consultation/analysis and advisory’ services as distinct from ‘private tuition’.

Neil Warren, independent VAT consultant said the case ‘highlights the importance in the VAT world of really getting to grips with the nature of goods or services being supplied by a business. What is the commercial reality of the transaction in question?

‘This reality cannot be superseded by how a sales invoice or contract is worded; it is what is being supplied that counts.’

Ruth Holmes (TC1207)

Design and build contracts

Zero rate remains in spite of planned change

Following representations to HMRC on proposed changes to the VAT liability of design and build contracts, the department has agreed they will continue to be zero-rated where the construction itself qualifies for VAT at the zero rate.

If a builder provides zero-rated building services, other professional services provided to the property owner – design and build – has always followed the same VAT liability as the building work.

HMRC recently issued a proposed draft to amend public notice 708 – prompted by the European Court of Justice’s decision in *Talacre Beach Caravan Sales Ltd v CCE* (Case C-251/05) [2006] STC 1671 – to change this approach so that a builder would have had to split an invoice on a zero-rated job between professional fees and building work, and charge VAT on the former.

Had the change gone ahead, the additional VAT costs would have been largely irrecoverable by the housing association, charity and not-for-profit sectors.

The Revenue will amend the public notice to identify the circumstances in which services of architects, surveyors and similar professional services included within lump sum, design and build contracts may continue to be treated as a composite supply of zero-rated construction services.

Baker Tilly’s Steve Hodgetts welcomed this response from the taxman, saying, ‘As housing associations are responsible for developing more than 50% of new homes in the UK, the additional VAT costs associated with the proposed change in policy would have adversely affected many affordable housing construction programmes.

Likewise, Peter Jenkins technical adviser to the Charity Tax Group, remarked, ‘The proposed change would have substantially increased the VAT cost of many charity construction projects. This is a good example of the generally positive and constructive relationship between HMRC and CTG on key issues facing the sector.’

Keeping accurate records

The taxpayers, a husband and wife who were in business together, bought second-hand cars, which they insured and then licensed to local taxi drivers for a fee of £120 a week, for a maximum 12-hour shift each day. All the drivers worked for one local firm, Bounds Taxis.

The taxpayers were responsible for repairing and maintaining the vehicles, but the drivers had to pay for fuel. The maximum potential income for each car was £240 a week.

As a result of an enquiry into the taxpayers’ tax returns, HMRC alleged the couple had under-declared their profits, and the department issued discovery assessments to collect the outstanding tax.

The increased profits meant the taxpayers should have registered for VAT, so best-judgment assessments for VAT were also made and penalties imposed.

The taxpayers appealed, arguing HMRC's calculations were inaccurate.

The couple's record-keeping was very poor and, because drivers paid them in cash, there was no way of verifying amounts received by reference to bank statements.

The Revenue obtained extra evidence by looking at taxi licences with the local authorities, and also from analysing charges made by Bounds Taxis to the taxpayers in relation to radio rentals.

The taxpayers kept a 'blue book' to record sales in one of the years under review and, although the book showed a higher sales figure than initially declared on the self-assessment tax return, the record was consistent with information from Bounds Taxis.

The tribunal accepted that the figure in the book was 'substantially correct' and used this figure as the basis for checking whether declared figures for other years were reasonable. It said the date of VAT registration (and any late registration penalty) should be recalculated based on the new figures.

The taxpayers' appeals in respect of the years 2003/04 to 2005/06 were allowed, but those for the earlier years were dismissed. The tribunal also reduced the penalty in respect of the unpaid income tax from 40% to 20%.

The decision demonstrates the importance of keeping accurate records. Neil Warren, independent VAT consultant, said, 'Inadequate record-keeping gives HMRC extensive powers to use a "best judgment" basis of calculation to establish what they consider to be an accurate sales figure for VAT purposes as far as either the VAT registration threshold or output tax liability (once a business is registered) is concerned.'

K Duhra and P Duhra (TC1182)

VAT default surcharge **(Lecture B680 – 28.27 minutes)**

This article reviews recent developments on default surcharge. It reviews the rules and selects some of the recent cases to illustrate some of the important points; the notes that follow summarise a greater number of recent examples of disputes that have gone to the First-Tier Tax Tribunal.

Notice

HMRC have issued an updated version of the notice on *Default Surcharge*. This is a reminder that, even though the F(no.3)A 2010 contained provisions to extend the new late filing and payment penalties to VAT, these have not yet been implemented and default surcharge remains in force for the foreseeable future.

Notice 700/50

Defaults

There has been a deluge of appeals about default surcharge, probably reflecting the difficult economic conditions faced by traders. Bear in mind that a trader who has agreed a time to pay arrangement is not subject to default surcharges; HMRC can rightly say that they will help those who plan ahead. In the majority of cases, HMRC win these appeals – although not in every one.

Successful default appeals

A barrister paid his quarterly VAT liability in cash at the Bank of England on 6 October 2009. HMRC did not process the receipt until 9 October, and issued a surcharge. The Tribunal held that the barrister, based on his knowledge of banking law and practice, had a reasonable expectation that the payment would be received on time, and cancelled the surcharge.

Part of the problem was that HMRC changed their banking arrangements on 8 July 2009, so that they no longer used the Bank of England collection account. HMRC had written to the barrister in earlier periods suggesting that his chosen method of settling his VAT liabilities created problems, but the Tribunal concluded that cash payment did give immediate value to HMRC and the "reasonable belief" that the payment would be received in time was a reasonable excuse.

First Tier Tribunal (TC01120): *Dingle Clark*

The first trader since *Enersys* to succeed with the "disproportionate" argument may force HMRC to address the issue again. Their failure to appeal *Enersys* to the Upper Tribunal may have been based on the belief that the circumstances were so particular that the decision would not be repeated; the argument has been put forward in many of the appeals about surcharges since, but has not up to now been accepted.

The company had been brought within the surcharge regime by two occasions on which it filed its VAT returns and subsequently made small adjustments to the figures, disclosed to HMRC, which resulted in additional payments (£476 added to £125,000 for 05/08; £331 added to £108,000 for 11/08). These were logged as defaults because not all the VAT due had been paid; this led to the issue of a SLN and the raising of the percentage from 2% to 5%, but no surcharge on such small amounts. These appeared to have arisen from an unsatisfactory accounting system which had subsequently been replaced.

The company was then a day late paying £85,000 for 07/09, and was charged a surcharge at 5% of £4,260.

Judge Redston was careful to explain why she chose to follow *Enersys* and not the other decisions:

In coming to our conclusion we noted in particular the lack of correlation between the single day of delay and the quantum of the penalty; the relationship between that quantum and the Company's profits; the sudden jump in surcharge from zero to over £4,000 and the Company's generally good compliance record both before and since this default period. We also considered it relevant that, in the first two default periods, over 99.5% of the amounts due had been paid on time.

The appeal was allowed on the basis of disproportionality and the surcharge was cancelled.

First Tier Tribunal (TC01341): *Total Technology (Engineering) Ltd*

An appeal against an income tax surcharge is not directly relevant to VAT, but the argument that the taxpayer used to succeed might be carried across to other taxes. Income tax surcharges are due if the balancing payment for a tax year is not paid 28 days after the due date (31 January following the tax year) and a further surcharge is levied on any outstanding amount after 31 July following.

A trader succeeded in convincing the Tribunal that the *Steptoe* argument should be applied to his income tax payments. He had not received full payment from a company which had employed him, and this had caused such financial difficulties that he was unable to pay his tax. The Tribunal considered that this was a finely balanced question, but decided that these were circumstances beyond his control. It may have helped his case that HMRC did not bother to send a representative to the hearing, relying only on a written statement of case which pointed out that the onus was on the appellant to demonstrate a reasonable excuse. At the first hearing, the appellant told his story, but did not produce evidence that the Tribunal could rely on; he was then given an opportunity to return for a second hearing with the evidence, which the Tribunal found convincing.

First Tier Tribunal (TC01220): *Gary Knapper*

Another income tax surcharge was struck out on the basis that the taxpayer had reasonably assumed that his tax affairs were in order. He had told his accountants that he was receiving self-employed income in April 2007. The accountants informed HMRC in April 2008, but received no reply. When they finally submitted returns on his behalf for the tax years 2006/07 to 2009/10 in April 2010, HMRC imposed surcharges for 2007/08 and 2008/09. The taxpayer appealed, arguing that he had provided details to his accountants within the relevant time limits and he had reasonably assumed that his accountants would have dealt with the information in a timely manner.

"Reliance on another" is precluded from being a reasonable excuse for VAT purposes by s.71 VATA 1994, but there is no similar provision for income tax. The chairman followed an income tax precedent set by the Special Commissioners, *Rowland* (SCD 536), and found that the reliance on the accountants was a reasonable excuse.

First Tier Tribunal (TC01380): *S Rich*

A company changed its name in November 2008 and its address in August 2009. In spite of this, HMRC sent surcharge notices using the old name to the old address. The director of the company was in any case suffering from stress and was being assisted by the directors of a supplier, who had a floating charge over the assets of the company.

The first they knew of a problem about surcharges was the arrival of bailiffs (at the new address) to levy distress on the assets for non-payment of the surcharges.

The Tribunal found that the company had tried to notify HMRC of its changed name and address and HMRC had failed to alter its records. The surcharge notices were therefore not validly issued to the taxpayer and the appeal against the surcharges was allowed.

First Tier Tribunal (TC01339): *DWS Environmental Ltd*

A company was partially successful with a surcharge appeal on similar grounds – it had moved, and HMRC appeared not to have amended their records in good time. One surcharge (levied before the change of address) was confirmed, as there was no reasonable excuse; the other surcharges were quashed, because the Tribunal was satisfied on the basis of the evidence that the company had not received the surcharge liability notices. It was strengthened in this conclusion by the fact that the office manager, who gave evidence under cross-examination, responded immediately to the last such notice to be issued – that was the reaction the Tribunal would have expected her to have had if she had received any of the others.

First Tier Tribunal (TC01296): *Mass Information Systems Ltd*

A business succeeded in persuading the Tribunal that its shortage of funds fell within the *Steptoe* principle and could therefore constitute a reasonable excuse. A combination of defaulting debtors and a bank unwilling to extend facilities constituted factors beyond the trader's control which led to the shortage. The appeal was allowed.

First Tier Tribunal (TC01279): *JMS Aggregate Supplies*

Unsuccessful default appeals

A trader was late three times before the surcharge was triggered (as the 2% and 5% surcharges were below £400). He paid a 10% surcharge without realising what it was, and then appealed against the 15% surcharge for the fifth successive late payment. The excuses offered amounted to "ignorance of the law" and "insufficiency of funds", and these could not be "reasonable". An argument based on proportionality was also rejected.

First Tier Tribunal (TC01072): *Robert Ward t/a WPS Electrics*

Another trader appealed against a 10% surcharge and two 15% surcharges totalling £9,816. It was accepted that the VAT had been paid late. The trader's appeal seemed based largely on dissatisfaction with HMRC's approach to dealing with business, and the assertion that the penalty was "disproportionate". The Tribunal held that the trader had been fully aware of the surcharge system and appeared to have substantial assets; the appeal was dismissed.

First Tier Tribunal (TC01040): *Codicote Quarry Ltd*

A trader attempted to pay a VAT liability of £16,000 by internet, only to find that she could only pay £10,000 on any day. In the event, she was in any case a day late with the first £10,000 (which arrived on 8 October 2009) and two days late with the balance. HMRC levied a 5% surcharge.

The Tribunal could not find any reasonable excuse, nor did it consider the penalty disproportionate.

First Tier Tribunal (TC01045): *Auko Ltd*

The proportionality argument was considered in some detail in a case in which a trader took on a large new contract on which the customer had 45 days to pay. This meant that the VAT liability for the quarter was unusually high, but the customer had not provided the funds to settle it. A time to pay agreement was reached some time later, but not in time to rule out a 10% surcharge.

The Tribunal commented that "proportionality" in this context did not relate to the length of time that the money was outstanding. Surcharge was a penalty for failure to comply with the law, not a substitute for interest for the use of the money. Although the surcharge might be harsh, it could not be said to be manifestly unfair in these circumstances.

First Tier Tribunal (TC01037): *Kaizen Search Ltd*

A firm of solicitors paid five successive VAT liabilities late. They appealed against the 15% surcharge on the fifth, claiming that this was a "genuine mistake" by an employee with 38 years' experience and the penalty was unduly harsh for a small business struggling in a recession. They did not bother to turn up for the hearing, possibly having looked up the law and realising that they could not possibly win.

First Tier Tribunal (TC01104): *Leonards Solicitors Ltd*

A company had been in the surcharge regime since November 2007. A surcharge for November 2009 was levied at 15%. The company claimed that the facts were identical to those in *Enersys Ltd*, and the penalty of £1,365 should therefore be cancelled because it lacked "proportionality".

The Tribunal considered that a 5% surcharge amounting to £130,000 was materially different from the present case. Proportionality had to be considered, but the defence was not helpful here.

First Tier Tribunal (TC01113): *Digitop Ltd*

A company paid £75,000 of its £178,000 liability on 12 November 2008 and the balance by further CHAPS transfers on 18 and 24 November. It was within the surcharge regime and the applicable rate was 5%. The trader's initial appeal was based solely on proportionality, but at the hearing the witness referred to exceptional difficulties in cash flow caused by the finance company which it dealt with. Both parties were invited to make submissions on the issue of reasonable excuse.

Unfortunately, the material provided by the company did not demonstrate that the financial difficulties were exceptional and unavoidable. In the context of a business with a £23m turnover, even one with very small profit margins, a £5,000 surcharge did not appear disproportionate to the Tribunal. The appeal was dismissed.

First Tier Tribunal (TC01137): *Mill Lane Engineering (Aldershot) Ltd*

A company's excuse amounted to little more than the harshness of the surcharge (another trader charged at 15%) and general shortage of funds – although the decision also refers to "the weather and other circumstances". None of this could be a reasonable excuse.

First Tier Tribunal (TC01136): *MTS Recovery & Repairs Ltd*

Yet another company with a 15% surcharge rate pleaded the absence of an administrative assistant on a course relating to dealing with an autistic child, and difficulties with a software upgrade. The Tribunal held that this was "reliance on another" and not a reasonable excuse.

First Tier Tribunal (TC01102): *Digital Solutions Technology Ltd*

Yet another trader was subject to the 15% rate of surcharge. The penalty for the return under appeal was £18,500. Its history of defaults showed that it was not always late – after suffering a 5% surcharge it filed and settled three returns on time, but failed to escape the surcharge regime because it missed the deadline for the fourth period. The chairman was troubled by the harshness of the penalty for a single day's delay, and considered the possible application of the *Enersys* principle of "disproportionality" in detail. He considered that the following factors had to be taken into account:

(1) whether the default was "innocent" or "deliberate";

(2) the number of days of the default;

(3) the absolute amount of the penalty, about which he said "The absence of an upper limit may be justifiable upon the basis that it is a necessary consequence of a tax-geared penalty, though in my view there must come a time, even in the case of a large company, when that justification breaks down";

(4) the "inexact correlation of turnover and penalty"; and

(5) the absence of any power to mitigate.

On balance, he decided that the penalty was harsh but not manifestly unfair in all the circumstances. It was clear that the company could have paid £100,000 of the £123,000 liability by the due date, so avoiding 80% of the penalty. The appeal was dismissed.

The chairman pointed out that HMRC's standard letter imposing a surcharge states that 'you cannot appeal simply on the grounds that you consider a surcharge is too severe'.

He pointed out that following *Enersys* this is not true, although the case shows that the circumstances have to be really exceptional for such an appeal to succeed.

First Tier Tribunal (TC01155): *Eastwell Manor Ltd*

A company defaulted five times, but it appealed only against the third (£8,000) and fifth (£27,700). The company claimed to have filed the third return on time – but the chairman pointed out that the receipt of an estimated assessment and a surcharge liability extension should have alerted the directors to the fact that it had not arrived. It was eventually filed six months late.

The excuse for the fifth period was effectively “shortage of funds”. It blamed late payments by its largest customer, which accounted for 76% of its turnover. HMRC analysed its income and receipts, and argued that late payment by this customer was not the only cause of its shortages of funds. The Tribunal agreed that the circumstances did not fall within the *Steptoe* principles. There was no reasonable excuse.

First Tier Tribunal (TC01158): *E&P Painting Contractors Ltd*

The UK subsidiary of an Italian company was within the payments on account regime. On transferring its records to SAP it was late filing a return and therefore entered into a surcharge period. It did not argue that it had a reasonable excuse for this period.

For the period to 30 September 2010, the VAT return was submitted on time, showing a liability of £1.135m. An accounts clerk keyed in to the electronic payments system a payment of £11.135m – £10m too much – on 29 October, which would have been in time to make the payment. The error was picked up too late to make a payment in time, so no money was transferred to HMRC by the due date. The 2% surcharge amounted to £22,700.

The company claimed a reasonable excuse on the basis that the bank should have notified it of the error earlier in the day. The Tribunal did not see any evidence that the bank had made an error, but in any case that would be prevented from being a reasonable excuse by s.71 VATA 1994.

The Tribunal considered proportionality in some detail, and compared the situation to *Enersys*. It noted that the liability for the quarter in *Enersys* was unusually high, which was one of the reasons why the penalty was considered exceptionally harsh; in this case, the period had a relatively low liability for this company. The fact that the company left the payment until the last possible date, that two officers failed to pick up the error in spite of knowing that they were within the surcharge regime, and the fact that the penalty was only levied at 2%, all persuaded the Tribunal that *Enersys* did not apply.

First Tier Tribunal (TC01158): *Luxottica (UK) Ltd*

Another 15% penalty was appealed on the basis that the Christmas and New Year holidays had combined with a family bereavement to cause the delay. This was the eighth successive default. However, in respect of six of these periods, no surcharge had been levied because the amount was too small or an exceptional agreement had been reached with HMRC.

It transpired that the bereavement had taken place five days after the late payment. Although one director had visited the sick relative (his wife’s aunt) in hospital, it did not appear that the other director should have been so distracted. The VAT return itself was received on 27 December, suggesting that the office was not completely closed over the period. The Tribunal found no excuse.

First Tier Tribunal (TC01166): *North Cooling Ltd*

A company used electronic funds transfer for the first time for its 08/10 quarter. It failed to appreciate that a BACS transfer can take three days to clear, and was issued with a surcharge. After a review, HMRC cancelled the surcharge, but sent a letter explaining the delays inherent in using BACS.

The payment for the following quarter was also late. It was debited from the company’s account on 7 January 2011, but was not received by HMRC until 11 January (because of an intervening weekend). The penalty rate was 15%. Not surprisingly, the Tribunal thought that the explicit warning from HMRC ruled out any possible excuse that the company might have had.

First Tier Tribunal (TC01199): *ADM Glass Ltd*

A trader argued that the surcharge liability notice was unclear – he had rung the National Advice Service to try to clarify what it was about, but was still confused. He thought that "default" had the meaning of "default setting on a computer".

He was also in the unfortunate position of incurring his first actual surcharge at the 10% level, because earlier surcharges had been below £400. The Tribunal adjourned to await an appeal in the *Enersys* case before considering whether the surcharge was disproportionate. When HMRC did not pursue that appeal, the Tribunal reconvened and went through the tests of disproportionality that had been set out in *Kaisen Search Ltd*:

- The gravity of the default, in particular to what extent the taxpayer was at fault;
- How long the VAT was outstanding;
- The amount of the surcharge relative to the wealth of the defaulter.

None of these criteria suggested that the penalty was unfair. The Tribunal also considered whether the fact that the turnover for the quarter in question was higher than normal, resulting in a higher penalty, made the penalty unduly harsh. It concluded that it did not, and the surcharge was confirmed.

First Tier Tribunal (TC01254): *Neshama Music Ltd*

A trader suffered a surcharge of £3,000 at the 5% rate after two late payments and one late return. There were a number of factors which might have contributed to a reasonable excuse (change of address leading to SLNs going astray, difficulties with online payments) or the defence of posting the return on time knocking out one of the earlier defaults. However, insufficient evidence of any of these matters was placed before the Tribunal, which could therefore not find any excuse. The surcharge was also not considered disproportionate, being some 1% of turnover.

First Tier Tribunal (TC01266): *Impossible TV Ltd*

Another trader suffered his first default surcharge (£676) at the 10% rate for the usual reason, that previous surcharges were too small to be collected. His excuse amounted to a belief that the due date for submission of EC Sales Lists was also the due date for payment of VAT; even if that was accepted, his payment arrived a day after that, and the surcharge was confirmed.

First Tier Tribunal (TC01274): *W Oswald*

A trader suffered a 5% surcharge amounting to £1,400. The excuses offered included a "surprise" holiday for the bookkeeper, confusion between the due dates for VAT and PAYE, and non-receipt of the notification of earlier defaults. The chairman did not accept that the directors could have been unaware of their defaults, as there was evidence of negotiation of payment terms; and the bookkeeper was in the office on the day the cheque should have been sent – the surprise holiday came later. The appeal was dismissed.

First Tier Tribunal (TC01273): *Grant Vehicle Repairs Ltd*

A trader's appeal against a surcharge was dismissed in his absence. He successfully applied to have that decision set aside, and was granted two postponements of further hearing dates. When he failed to turn up to the next hearing, the Tribunal decided to hear the case in his absence again.

The chairman noted that the appellant had incurred more than 50 surcharges between 1992 and 2007. In connection with the current appeal against surcharges for three periods, the trader had offered only one thing that could possibly constitute an excuse: financial difficulties created by HMRC putting the tenant of a rental property into liquidation. The Tribunal could find no connection between this event and the defaults. Without evidence of cause, the appeal could not succeed.

First Tier Tribunal (TC01241): *Graham Roth t/a Phillips Roth & Co*

An employment agency, specialising in unskilled farm labourers, defaulted five times. It appealed against the surcharges and accompanying extension notices for the third, fourth and fifth of these. The company had assumed throughout that BACS transfers would reach HMRC immediately, and had ignored warnings about the need to make sure the money arrived by Friday where the due date was on a weekend. The Tribunal dismissed the appeal.

First Tier Tribunal (TC01239): *CV Staff Services Ltd*

A trader argued that it had been unable to pay its VAT on time because of a delay in receiving money from Essex County Council, whose accounts department closed for six weeks in the summer. The Tribunal found that the invoice to the council was raised after the quarter concerned – the business should have put aside money from other customers to pay the VAT as it fell due, and should not have relied on the proceeds of a later sale. Even if the shortage of funds for this reason could have been a reasonable excuse, the trader had left it very late to send out the invoice; it should have been realised that a time to pay agreement was needed. The appeal was dismissed.

First Tier Tribunal (TC01369): *Fury Design Consultants*

A trader had been warned several times about the transmission times for bank transfers, so the Tribunal had little sympathy with his attempt to pay by electronic transfer on Sunday 6 February – the payment arrived on 9 February and a 15% surcharge was imposed. Previous surcharges had been waived; in the circumstances, a penalty of £1,000 was not considered "plainly unfair" or disproportionate. His appeal was dismissed.

First Tier Tribunal (TC01370): *Pound Road Stores Ltd*

A subsidiary of a German company fell into the surcharge regime and suffered a surcharge when it submitted a return and applied to pay the tax by direct debit. Normally 10 days are allowed for payment by DD, but the return was submitted too late for HMRC to process the application in time. As a result, the payment arrived late and a surcharge at 5% (later reduced to 2% after an earlier surcharge was "forgiven") was levied. The company appealed against the charge (£8,700 at 2%).

The excuse offered was mainly the difficulty of understanding the payment instructions and default surcharge warnings for someone who was not a native English speaker. The senior management wanted to comply but they had been confused.

The Tribunal did not accept that this could be a reasonable excuse. The company was aware that there was a problem, but failed to consult its UK accountants to help resolve it. The appeal was dismissed.

First Tier Tribunal (TC01356): *Feldbinder (UK) Ltd*

A company mistakenly believed that it had a "time to pay" arrangement in place. There was no other reason for the payment to be late, and a 5% surcharge of £1,490 was confirmed.

First Tier Tribunal (TC01348): *Amber Valley Developments Ltd*

A company appealed against successive default surcharges for six periods. It appeared that the main excuse offered was a misunderstanding by the director about the due date for making electronic payments. He also argued that the surcharges (all at 15%) were an "excessive interest charge". The Tribunal did not consider any of this to be a reasonable excuse, and did not think that the "disproportionate" defence applied.

First Tier Tribunal (TC01349): *Intabase Solutions Ltd*

A large company was 11 days late paying a payment on account, and was charged a 2% surcharge of £50,000.

It appeared that an earlier payment was 4 days late because of staff absence due to sickness, so the company entered the surcharge regime from 1 October 2009. As part of an internal investigation into why this had happened, the VAT manager noted that the POA were higher than they needed to be and applied for them to be reduced. This was done, but for some reason the new schedule of POA that should have applied from the end of May 2010 was not picked up by the finance department. The failure to pay any VAT was only noticed after preparation of the management accounts in early June, and so the payment of some £2.5m was 11 days late.

The VAT manager suggested that the conclusion had to be the same as the judge reached in *Enersys*: "no court or tribunal, with the power outlined by Judge Bishopp, would impose a £50,000 penalty on the Appellant in this case". The chairman distinguished the present situation on the grounds that the delay was longer. While the penalty might be very harsh for an inadvertent error of this type, it was not so plainly unfair where the delay was 11 days rather than a single day.

First Tier Tribunal (TC01302): *Saint-Gobain Building Distribution Ltd*

Another taxpayer appeared to have misunderstood the required payment date for electronic transfers, but the issue of earlier surcharges and notices should have drawn his attention to the problem. Although the company was not represented and had not raised the argument, the Tribunal considered the "disproportional" point anyway, and decided that the surcharge at 5% was not unduly harsh.

It was noted that an earlier surcharge of £409.70 should have been levied at 2% rather than 5% (and therefore not levied at all); HMRC had raised the percentage when only the return had been late, not the payment. HMRC's representative undertook to make sure that the surcharge (which had been paid) would be refunded to the taxpayer.

First Tier Tribunal (TC01316): *Preferred Refrigeration Ltd*

Another appellant had a surcharge reduced from 5% to 2% on review, but the Tribunal could find no excuse for the default and did not consider the penalty of £699 unduly harsh. The company had paid its VAT liability of £34,967.10 in four instalments on 8, 9, 13 and 15 September, mainly because the bank would not process electronic payments of more than £10,000 on any day.

The Tribunal noted that it had not occurred to the director to make a payment by CHAPS, which would have resulted in the payment being on time. He had also preferred to pay his suppliers before HMRC. There was no reasonable excuse.

The director referred to the ECJ decision in *Louloudakis* (C-262/99) as well as *Enersys*. That was about a customs duty penalty, but the Tribunal agreed it was relevant: "*it seems to us that its relevance is that it makes plain that the test to be applied is whether a particular penalty provision goes beyond what is necessary, and that in determining whether a particular penalty is necessary to achieve an objective the gravity of the default is a relevant consideration to be weighed against the object of the measure.*" Taking that into account, and working through the steps applied in *Enersys*, the Tribunal decided that the penalty "bore heavily" on the appellant but was not wholly unfair.

First Tier Tribunal (TC01300): *Blue Forest (UK) Ltd*

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