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FINANCE BILL 2012 (Lecture P691 – 23.34 minutes)

Following the Autumn Statement all eyes were focused on the Finance Bill 2012. For the second time in history the Government has issued draft legislation for the following years' Finance Act. The aim for David Gauke being to *"set out proposals for a more predictable and stable tax system, and a new policy cycle that allows proper time for scrutiny"*.

The story of this Finance Bill is an update on the prior years' consultations, of which there have been many. Some of the key ones include the following:

- Statutory definition of residence
- The reform of taxation for non domiciled individuals
- Pooling of capital allowances for fixtures and fittings
- The introduction of a patent box regime
- Controlled Foreign Companies

These are just a few of the many consultations that the Government have looked at in the past year. For many tax professionals it came as a surprise that the new statutory residence test will not be applicable for 2012/2013, although it does seem a case of "when", rather than "if" it will be introduced. In this summary we try to outline the main changes outlined in Finance Bill 2012 and give an indication of the impacts that these will have upon clients.

Are you resident, clearly or otherwise?

The headline that many people were waiting for, both inside and outside of the tax profession was delayed further, with the Government proposing further consultation and the inclusion in Finance Bill 2013.

With the aim of the legislation being to provide more certainty allowing for those with complicated affairs to quickly and easily determine whether or not they are resident in the UK, many advisers will welcome the introduction of such a test. This should help to reduce the cost of determining tax residence, whilst not affecting most people in the UK who are either clearly resident or clearly non resident.

The impact of this is that for clients who are already counting the number of days they spend in the UK, they will have to maintain this for an additional 12 months until the statutory residence test has been included in Finance Bill 2013.

Non domiciled Individuals – an incentive to change?

The Finance Bill 2012 will have several key impacts upon the taxation of non UK domiciled individuals:

1) Individuals who have been resident in the UK for 7 of the past 9 tax years will have the choice of whether to pay a £30,000 remittance basis charge, or be taxed on their worldwide income
2) Individuals who have been resident in the UK for 12 of the past 14 tax years will have the choice of whether to pay a £50,000 remittance basis charge, or be taxed on their worldwide income
3) From 6th April 2012, non domiciled individuals will be able to remit income to the UK free of tax where the purpose is to invest in unlisted companies, carrying out a trading activity or developing or letting commercial property
4) Simplification of the rules concerning the treatment of nominated income for the remittance basis charge (RBC)

The changes may go some way to encouraging non domiciled individuals to invest more in UK businesses; however the increase in the remittance basis charge for long term UK resident non doms may prove unpopular with many.

For many the impact of these changes will be that they or their tax adviser will need to calculate what their income tax and capital gains tax position would be depending on whether or not they paid the RBC or had their worldwide income taxed in the UK. This could mean further costs of compliance and lead to uncertainty around the amount of tax payable and when.

Foreign currency bank accounts

From 6th April 2012 where capital gains are made on the withdrawal of money in foreign currency bank accounts held by individuals, trustees and personal representatives of the deceased, these gains will be exempt from CGT. Similarly any capital losses made will not be allowable losses.

60% tax rate, here to stay....... temporarily

Finance Bill 2012 saw no changes to the additional rate of income tax, payable by those individuals with taxable income above £150,000. It is expected that further announcements will be made surrounding the top rate of income tax once the Treasury has measured the impact that has been made to the economy; this is expected to be in early 2012.

The personal allowance has been extended beyond the inflationary increase that was due for the year; however the basic rate band has been cut correspondingly to ensure that the threshold for becoming a higher rate tax payer does not change. See the example below for how this will save £126 in income tax for those continuing to earn £42,475.

	2012/2013	2011/2012
Income	£42,475	£42,475
Personal Allowance	(8,105)	(7,475)
Taxable	£34,370	£35,000
Tax payable at 20%	£6,874	£7,000

Gifts of pre eminent objects to the nation

The measures outlined will provide a tax reduction of 30% for individuals and 20% for companies where a gift of pre eminent objects is made to the nation. The amount of the tax reduction available will need to be agreed with a panel of experts who will consider the amount of value placed on the items by the self assessed valuation, they will then provide a valuation of the items and the individual/company concerned will decide whether or not to proceed. Individuals will be able to spread the tax reduction across a period of up to 5 years starting with the tax year in which the object is offered. These measures are expected to take effect from the day after the Finance Bill 2012 receives Royal Assent.

EIS and VCT thresholds to increase

The measures outlined will increase the threshold for EIS tax relief so that the maximum amount that can be invested by an individual in a tax year will rise to £1 million and will apply to the tax year 2012-2013, for which State Aid Approval has already been received.

The thresholds for the size of company that will qualify will also rise as follows from 6th April 2012, subject to State Aid approval:

- Employee limit will rise from 50 employees to 250
- The threshold of gross assets before investment will be increased from £7 million to £15 million, and from £8 million to £16 million after share issue

- The maximum annual amount that can be invested in the company annually will be set at £10 million

The impact of these changes is that an additional number of companies will now qualify as EIS and VCT companies. This means that for investors, there will be a greater range of investment opportunities with more established businesses qualifying.

Seed Enterprise Investment Scheme

This new tax advantaged form of venture capital scheme was announced at the Autumn Statement 2011; it will be focused on smaller, start up companies and will provide a form of relief similar to the EIS Scheme. This scheme will make tax relief available to investors who subscribe for shares and have less than a 30% stake in the company.

The main points to note are as follows:

- The type of company this applies to is one that has less than 25 employees with assets of up to £200,000 who are preparing to carry on new business
- This will apply to the subscription of shares, using the same definition of EIS Shares
- The annual amount allowed for relief each year for an individual investor is £100,000
- There will be an exemption from CGT for capital gains made on shares within the scope of the SEIS regime
- There will be an exemption for gains realised on disposals of assets in 2012/2013 where the gains are reinvested through the new SEIS in the same year.
- The individual investor will be given 50% income tax relief for the investment made and this will also be available for directors who invest in their company, provided they hold less than 30% of the shares.

The impact of these changes is that an individual investor may be able to obtain up to 78% tax relief from income tax and capital gains tax. If the shares also qualify for Business Property Relief the tax saving afforded could be even greater still. However, investors may find it difficult to find companies in which they can invest to obtain maximum relief which also provide a commercial return on investment.

Do you drive an armoured Volvo?

Amendments to the taxation of company cars will be introduced to reflect the fact that some company cars are above the old £80,000 cap on price for benefits in kind because of security reasons. The changes will include certain improvements to a car for security reasons as an "excluded accessory", these will include the following:

- Armour designed to protect the car from explosions or gunfire
- Bullet resistant glass
- Modifications to the fuel tank for security reasons
- Other modifications for the purposes of enhanced security

This will come as a welcome relief for those afforded the luxury of a company car that provides them with additional security that is required because of the nature of employment they hold.

Champions league 2013

The Government have announced that there will be an exemption from UK taxation for the non resident footballers and officials for the money that they earn in relation to the Champions League Final to be held at Wembley in 2013. UK residents involved in the final will be unaffected by this legislation.

Corporation Tax

The Government has made clear that they want to make the UK the "most competitive corporate tax system in the G20", so how do our rates of taxation compare to other countries in the EU for 2011?

- UK – From 20% to main rate of 26% on profits above £1,500,000
- Germany - 15% plus a surcharge of 5.5% of Corporation Tax
- France – 15% for SME's (first 38,120 Euros) with a main rate of 33.33% following that
- Italy – 27.5% for companies with turnover below 25 million Euros and 34% above this
- Spain – 25% on first 300,000 Euros for companies with turnover below 10 million Euros, the main rate being 25%
- Belgium – Main rate of 33% increased by 3% surcharge with a variety of rates for smaller companies from 24.5% to 35.54%
- Netherlands – 20% for profits below 200,000 Euros, 25% for profits above 200,000 Euros

It seems clear that the main rates of Corporation Tax for the UK are going in the right direction to make our tax system more competitive, although the size and breadth of the legislation enacted in the UK would appear to offset the reductions in main rate of tax.

For companies with annual profits less than £300,000 they benefit from a small profits rate of corporation tax of just 20%, an attractive inducement to settle in the UK. This is in addition to the reduction in the main rate of Corporation Tax to just 24% from April 2013.

Controlled Foreign Companies

The much awaited draft legislation on Controlled Foreign Companies (CFCs) has been released, showing the Government's intentions going forwards for this complicated area of taxation. The consultation period for this area of tax reform ended on 22nd September 2011 and the main changes that the Government have announced are as follows:

- The profits of a foreign subsidiary will be outside the scope of the new CFC regime unless they meet the specified conditions in a "gateway" test.
- The gateway conditions will define which profits have been artificially diverted from the UK
- Foreign subsidiaries will be able to rely upon "safe harbours" to show that either some, or all of its profits are outside the scope of the new CFC regime
- Safe harbours will include conditions covering commercial business, incidental finance and other sector specific rules
- The new regime will also provide specific exemptions for CFCs and have two main applications for excluded territories and a low profits exemption

The Government have estimated that the tax cost in making these changes will be reflected by a £100 million reduction in receipts per annum. The changes outlined have been made to "make the rules simpler to apply, exempting genuine foreign profits whilst better targeting artificially diverted UK profits". Although the measures included are likely to be included in the Finance Bill 2012, the effect of this upon companies is only likely to apply after the Finance Bill 2012 has received Royal Assent, however further consultation on this is still due.

Worldwide Debt Cap

As part of Finance Bill 2012, several changes have been announced which will affect the Worldwide Debt Cap. These changes will have effect for companies from the accounting period ending on or after the date that the Finance Bill 2012 receives Royal Assent.

The main changes announced are as follows:

1) There will be an opt out of the de-minims limits of the net financing deduction and net financing income amounts
2) There will be changes to the way the following are dealt with:
   - Mergers, acquisitions and de-mergers of groups
   - Dormant companies and the elections for companies to be treated as 'authorised dormant companies'
   - An anti avoidance provision will be introduced and the power to make regulations to deal with the proposed changes in accounting standards for consolidated company accounts
3) The Government also expects to make changes to the rules concerning mismatches from loans to a partnership and asset backed pension contributions

Patent Box

The Government have announced that from 1st April 2013, companies with qualifying Intellectual Property (IP) Patents will be able to elect to apply a 10% rate of Corporation Tax. The aim of this policy is to "provide an additional incentive for companies to retain and commercialise existing patents and to develop new innovative patented products". The guidance published sets out a structure for calculating the profits attributable to qualifying IP. Qualifying IP will include patents granted by the UK Intellectual Property Office and the European Patent Office. It is also planned for a Targeted Anti Avoidance Rule (TAAR) to be introduced, which will provide comprehensive guidance on this area of taxation, which is likely to be published in summer 2012. The consultation on the Patent Box regime is planned to end on 10th February 2012.

Research and Development

The Finance Bill 2012 clearly set out the Government's intentions to get the UK creating more innovation and drive research by increasing the amount of reliefs available. The changes to the R&D regime are as below and will have effect from 1st April 2012:

- Clarification will be provided on when a company is to be regarded as a "going concern", meaning that where a company is either in administration or part of liquidation proceedings R&D relief will not be available
- SMEs – The additional deduction available will be increased from 100% to 125%, giving a total deduction of 225% of the actual costs incurred
- Loss making SMEs – the rate payable for surrendered losses will be reduced to 11% of the loss
- The rule restricting the R&D claim made to the company's PAYE/NIC liability will be removed
- For both SMEs and large companies the minimum expenditure requirement of £10,000 per annum will be removed and the definition of an externally provided worker will be widened to increase the scope for this element of the relief

With such a great opportunity to help clients reduce their tax bill and even improve their cash flow by surrendering R&D losses; this is an area that tax advisers can really take advantage of to help their clients in the coming Financial Year. Further consultation on this is planned as part of the 2012 Budget and the changes are expected to be introduced in April 2013.

Capital Allowances on Feed in Tariffs

From 1st April 2012 for companies and 6th April 2012 for individuals, there will be a change to the capital allowances regime for items of plant and machinery that attract a Feed in Tariff (FiT) or tariffs under the Renewable Heat Incentive (RHI). The changes to the capital allowances regime will apply from April 2014 where the expenditure is in respect of combined heat and power equipment.

Finance Bill 2012 will introduce legislation that means expenditure on solar panels will be treated as special rate expenditure from April 2012; however AIA will still be available for these amounts. Enhanced Capital Allowances will no longer be available where the plant or machinery generates electricity or heat that attracts payments under the FiT or RHI schemes. Where an ECA is provided, it will be withdrawn if the plant or machinery subsequently receives a payment under either tariff subsequently.

Fixtures

The Government has proposed several key changes to the way that a purchaser of a building can claim capital allowances on fixtures. These will have effect from 1st April 2012 for companies and from 6th April 2012 for individuals. These changes will mean that the ability to claim allowances will depend on:

1) The previous expenditure on qualifying fixtures being pooled before a subsequent transfer to another person; and
2) The seller and purchaser fixing their agreement of the value of the fixtures to be transferred, this need to be done within two years of the transfer; or
3) The past owner provides a written statement of the amount of the disposal value of the fixtures which he had been required to bring into account at some earlier time; he must do this within two years of the transfer of the property.

The purchaser and seller can currently agree to fix a price either by jointly electing for any part of the sale price to be attributed to fixtures, or if the two parties can't agree on the value attributed either of the parties will be able to refer the matter to a First Tier Tribunal for an independent determination. The impact of these changes is that it will now be even more important to consider the capital allowances position when the building is being sold, preferably with the individual/company seeking tax advice in advance of the transaction.

ESC C16

Legislation is going to be introduced to give statutory effect to ESC C16, the reason being that the Government wishes to reduce the uncertainty faced by shareholders when having their company struck off. The operative date that has been proposed by the Government for this is 1st March 2012. The legislation is to propose that where a distribution is made by a company prior to its dissolution then it will not be treated as a distribution for the purposes of the Corporation Taxes Act, so long as the total distributions do not exceed £25,000. The order will also amend TCGA 1992 to treat this type of distribution as a capital distribution.

Extra statutory concessions

A list of ESCs that the Government is proposing to withdraw has been published and a response from those affected has been called for by 30th November 2012. It has been stated that the withdrawal of these concessions is planned from 2013/2014, allowing for at the very least a full years notice. It has also been stated very clearly, that no ESC will be removed retrospectively. The concessions which are being consulted upon are as follows:

- A12: Double taxation relief: alimony etc under United Kingdom court order: payer resident abroad
- B1: Machinery or plant: changes from 'renewals' basis to capital allowances basis
- B49: Section 532 CAA 2011: Grants repaid
- EIM23470: Company cars for disabled without blue badges
- Filing extension for P11D(b)

If you have clients who may be affected by these proposals you should contact Emma Cartledge at HMRC Central Policy before the closing date for comments.

VAT – Low Value Consignment Relief

It has been recently been publicised that Low Value Consignment Relief (LVCR) has been reduced from £18 to £15 from 1st November 2011, from 1st April 2012 the relief will be withdrawn completely for goods imported from the Channel Islands. This means that between 1st November 2011 and 1st April 2012, the new reduced rate of LVCR will apply to goods imported from the Channel Islands. The measures have been introduced to ensure that UK businesses are able to compete on a level playing field.

VAT on road vehicles brought into the UK

As part of the initiative between HMRC and the DVLA, 2013 will see the need for drivers bringing a new or used road vehicle, for use in the UK on UK roads to notify HMRC of the arrival within 14 days. This will also need to be done before the vehicle is registered with the DVLA. For individuals or non VAT registered businesses any VAT due must be paid at the time of notification. It will not be possible to licence and register the vehicle until HMRC has been notified and the VAT paid.

There will be several exceptions to the notification procedure including:

- Visitors bringing their vehicles into the UK temporarily
- UK residents returning from a holiday with their road vehicle
- Private importers
- Vehicles brought into the UK under secure schemes approved by the DVLA

With these changes to the rules many clients may be caught unaware and find themselves paying additional VAT that they have not budgeted for.

VAT – Removal of the threshold for Non UK Established Businesses

With effect from 1st December 2012 the threshold for VAT registration for non UK established businesses will be removed entirely where they are making taxable supplies in the UK. The Government have announced that a new schedule 1A will be created and existing schedules will be amended where appropriate.

Lost reliefs

The OTS has announced a number of tax reliefs to be abolished from April 2012, with the key ones being:

- Class 1 NIC Exemption for certain apprentices and students coming to the UK
- Class 1A NICs exemption for prescribed general earnings
- Certain payments made to mariners to be disregarded for Class 1 NICs

The Government have also confirmed that the following reliefs announced to be abolished from April 2013 will go ahead as planned:

- Cycle to work days: provision of meals
- Luncheon vouchers: exemption from Class 1 Nics
- Mineral royalties
- Disadvantaged areas relief for SDLT
- Capital allowances: safety at sports grounds
- Capital allowances: flat conversion allowances
- Grants for giving up agricultural land

Following consultation HMRC have decided "for exceptional reasons", not to abolish the following reliefs:

- Late night taxis
- Land remediation relief
- Compensation for mis-sold pensions
- Class 1 NICs exemption for payments as a reward for assistance with lost or stolen credit cards

Do you do digital?

Whilst the majority of people within the UK tax system will be comfortable using online channels it has become increasingly clear the focus of HM Revenue and Customs will be in taking most processing and compliance functions online. It is therefore increasingly important for tax practitioners to ensure that they have both safe and efficient internet access and facility to make submissions of returns of a variety of types online.

What's next?

So now that we've had the Autumn Statement and draft clauses for the Finance Bill 2012 announced, the next step will be further consultations on the items announced ending on Friday 10th February 2012. Following that the Budget for 2012 will be announced, outlining the exact details of the tax changes to be introduced. As David Gauke said in September *"The Government's approach to tax policy making puts consultation on policy and scrutiny of the legislation as the cornerstones"*. With so much happening the key challenge will be to maintain an awareness of the changes that will impact upon your clients.

Tolley Tax Intelligence, December 2011

PERSONAL TAX

Payments derived from employee benefit funds

The taxpayer was an international group company, resident in the United Kingdom, with subsidiaries and branches in over 20 countries; offering consultancy services. It was an employee-owned service company with employees resident in many parts of the world. Annually, the taxpayer paid a substantial proportion of its profits into employee trusts from which awards were made to employees under discretionary bonus schemes.

In 1999, a new bonus scheme was implemented, under which bonuses were to be paid as dividends of a UK-resident company and, consequently, taxed as distributions. A deed was executed in December 1999 establishing a new employee benefit trust (the 1999 trust) appointing, as trustee, a particular company (M). The stated purpose of the 1999 trust was "to motivate and encourage employees in the performance of their duties by the provision of bonuses and incentives and other rewards at the discretion of the trustees". The taxpayer transferred approximately £24m to M for payment into the 1999 trust, recording the payment as "staff costs" in its accounts. M then established a company (E), which at the time was non-UK resident. Shares in E were issued to M nominees and, in January 2000, E became UK-resident, with the result that its dividends fell within Sch F. In February, M transferred almost all of the £24m it had received from the taxpayer into E as a capital contribution, subscribed 24 million 1p preference shares at par and issued them to its nominee, J. M then granted individual awards of beneficial interests in almost all the preference shares to particular employees who had been identified by the taxpayer and J was instructed to hold those shares for those employees. In March, E declared a dividend of 99p on each 1p preference share from the profits represented by the capital contribution. The dividend was paid to J as the registered owner and thence, after the deduction of 25% income tax, to the selected employees. Essentially the same steps were repeated in the years 2000 and 2001.

An issue arose between the taxpayer and the Revenue as to how the payments were to be treated for tax purposes. The First-tier Tribunal (the tribunal) held that:

(i) the payments were to be treated as emoluments from employment within s 19 of, and Sch E to, ICTA;

(ii) the payments also constituted dividends or distributions within s 20 of, and Sch F to, ICTA;

(iii) pursuant to s 20(2) of ICTA, the payments were accordingly not chargeable to income tax pursuant to Sch E under reg 80 of the Income Tax (Pay as You Earn) Regulations 2003, SI 2003/2682; and

(iv) the payments were earnings within the terms of ss 3 and 6 of the Social Security Contributions and Benefits Act 1992 (the SSCBA) and thus subject to liability for Class 1 National Insurance contributions. The Upper Tribunal (Tax and Chancery Chamber) (the upper tribunal) adopted the same approach and reached the same conclusion as the tribunal. Both parties appealed.

Decision:

The Revenue submitted that the dividends were, in reality, bonuses and therefore had been liable to be taxed under Sch E and that Sch F and s 20(2) of ICTA had not applied. The taxpayer submitted that the income had not been from employment and, consequently, the decision that the payments received in the form of dividends were "earnings" for the purposes of SSCBA had been incorrect.

(1) The correct approach to determine whether the income receipts of an employee were emoluments or profits from employment was to consider all the facts relevant to the receipt of the income. That required the court to focus on the character of the receipt in the hands of the recipient.

The payment received by the employees had owed everything to the amount which the taxpayer had decided to award as bonuses to its employees. The quantum of that which the employees had received had been entirely dictated by the amount the taxpayer had decided to award as bonuses. The receipts had been triggered by the taxpayer's decision to continue its policy of making bonus payments and to fund the 1999 trust and had arrived in the hands of employees, as they were intended to do, as bonuses. The employees had been earners since they were gainfully employed in the UK under a contract of service with emoluments chargeable to income tax under Sch E. The receipts were, as held by the tribunal, earnings which, by virtue of s 3(1) of ICTA included any remuneration of profit from employment.

The taxpayer's appeal would be dismissed.

(2) Section 20(2) of ICTA had no application unless “a distribution chargeable under Sch F” was identified. It had no application to a payment chargeable under Sch E. Section 20(2) resolved the conflict where income from one and the same source, shares or certain securities, was charged under different Schedules. That section provided that they had to be taxed under Sch F. It was not concerned to charge income under Sch F when the source of the income was charged under the different and mutually exclusive Sch E.

Both tribunals had concluded that the payments were emoluments by having regard to all the circumstances of the case and by looking to the substance and purpose of the payments and not to the mere form in which they were received. Once that conclusion had been reached, there had been no room whatever for any further consideration of a different Schedule. Any other conclusion would have offended the settled, basic, principle that if income fell within one Schedule it could not be taxed under another. The tribunals had concluded, on an analysis of the facts, that the payments were from employment and that conclusion could not be impugned. It followed that income could not also be charged under any other Schedule. The tribunals had erred in thinking that both Schedules could be relevant. That had been incorrect as its factual conclusion that the income fell within Sch E had precluded any finding that the income also fell within Sch F. That conclusion was dictated by the structure of Pt 1 of ICTA and the application of fundamental principles of income tax law and not s 20(2) of ICTA.

The Revenue's appeal would be allowed.

Decision of Upper Tribunal (Tax and Chancery Chamber) [2010] STC 2343 Reversed In Part.

Comments - The Court of Appeal unanimously held that, although the payments took the form of dividends, they were in substance emoluments and within the charge to PAYE and NICs. This was a widely used methodology of paying bonuses at a particular point in time and demonstrates that although it is reliant on the interaction of certain legal provisions which were examined at both Tribunal levels such interaction did not withstand a more objective review at the Court of Appeal. The particular method of paying the bonus relied on the characterisation in the form of income not liable to PAYE and more importantly NIC. The Court of Appeal has decided however that since the source was the employment it was irrelevant as to whether it could be classed as a dividend. In light of the amounts of money passed through this bonus methodology an appeal to the Supreme Court seems likely.

Revenue and Customs Comrs v PA Holdings Ltd [2011] EWCA Civ 1414

Employed v Self-employed – Recent cases (Lecture B691 – 14.36 minutes)

Solving the question of employment versus self-employment is a constant almost an eternal one and one that gets no nearer to final resolution by a defined set of parameters. This article looks at a couple of recent cases which focus on different aspects of the tax legislation but centre around the key question of whether a contractual arrangement is one of employment or self employment.

The first is the case of Weight Watchers Limited v HMRC which went against Weight Watchers finding that the individuals should be treated as employees; the second is the case of Talentcore Ltd v HMRC where the relationship was not one of employment. The issue of costs in the Talentcore case is also considered briefly.

The key issue in Weight Watchers was that of whether the leaders were employees and therefore whether PAYE and Class 1 NIC should have been applied. However the issue with Talentcore is that of the application of the rules relating to agency workers – a different aspect of the income tax provisions which determines who has responsibility for employment taxes.

Before looking at the key issues it is worth reminding ourselves with a brief summary of the relevant facts of each case

Weightwatchers

The taxpayer company sold various weight-loss programmes. They were delivered by specially trained former members of the programme, known as "leaders" (the leaders). Between 2001 and 2007 the Revenue made PAYE and NIC determinations relating respectively to the income tax (PAYE) and employer's national insurance contributions payable by the taxpayer in respect of the activities of the leaders.

The taxpayer appealed those determinations, submitting that the Revenue had been wrong to class the leaders as employees. The First-tier Tribunal (the FTT) found for the Revenue.

In reaching its decision on the nature of the employment relations between the taxpayer and the leaders it applied the three-stage approach laid down in *Ready Mixed Concrete (SE) Ltd v Minister of Pensions and National Insurance* ([1968] 1 ALL ER 433) (*Ready Mixed Concrete*) for determining whether a particular contract was a contract of employment. To satisfy the test, it had to be shown, first of all, that there was a mutuality of work-related obligation; second, that the hiring party exercised a degree of control over the relationship; and third, that there was nothing else in the terms of the contract that placed it in a different category. The FTT found that the test was satisfied, to the extent that there was sufficient mutuality of obligation between the taxpayer and the leaders, and sufficient degree of control exerted by the former over the latter, to justify the finding that the leaders were employees. The FTT also found that there was nothing in the contracts between the taxpayer and the leaders that would militate against such a view. The taxpayer appealed.

The issues in the Upper Tribunal centred around issues relating the validity of the assessments and rather than the factors determining status.

Talentcore

Talentcore, which trades under the name "Team Spirits", is engaged in the supply of individuals to major cosmetic companies for counter and promotional work at airport duty-free shops. It has a database of about 100 individuals, who are referred to as "consultants". The duty-free shops are run by World Duty Free and it seems that Talentcore also supplies consultants to World Duty Free directly to assist in the normal operation of their duty-free shops.

Various aspects of fact were demonstrated at the FTT:

1 No framework contract between Talentcore and the consultants. Talentcore were free to offer work to them or not, and they were free to accept or decline work when offered.

2 There are no written contracts between Talentcore and either the cosmetics companies (or World Duty Free which runs the duty-free shops) or the consultants.

3 Talentcore would telephone consultants offering work on particular days in the morning (8 am to 2 pm) or afternoon (3 pm to 9 pm) shift. If a consultant accepted, a contract is entered into for such work. A rota is prepared of the names of consultants and sent to the cosmetics company and the consultants. The consultant obtains a signature on his time sheet by either someone present from the cosmetics company or a manager from World Duty Free.

4 When working there is little supervision of the consultants. There is no control over sales techniques employed by consultants. Normally nobody from the cosmetics company will be managing the promotion; the counter staff working for the cosmetics company will be managing the counter and will not be supervising the promotion. World Duty Free as operator of the duty-free shop will be in a position to give directions to the consultants.

5 Consultants who are unable or unwilling to work for an agreed slot are expected to inform Talentcore and if possible find a replacement. Evidence in the case included reference to specific consultants in respect of the substitution conditions:

> “Mr and Mrs Twine both of whom work for Talentcore change shifts between them from time to time. The situation where neither could work a particular shift had never arisen. Mr Kasmani considered himself totally free to send a substitute. This arose when his wife booked a holiday. Mr Hussane (who did not work for Talentcore during the time of the assessments) stated that he liked the idea of being able to delegate work or exchange work with a friend holding an airport identity pass, which he does without problems simply by telephoning a friend. Where substitutes are arranged at the last minute without informing Talentcore the consultant who agreed to work the particular shift will pay the substitute and claim the same amount from the Appellant. I saw three letters from other consultants not called as witnesses saying that they had engaged a substitute and paid them, and two others who said they knew they could do so but had not done it."

When Tribunals and others (such as HMRC status officers) are attempting to determine whether employment exists there are a number of factors that are often considered. The list which is not exhaustive includes:

- The engagers business
- The nature of the job
- how the engagement of the worker topok place
- What the contract actually says
- The control and the rights of control
- What work is to be done
- Where the work is to be done
- When the work is to be done
- How the work is to be done
- Whether personal service is required
- The provision of equipment
- Payments

- Exclusive services
- Substitution
- Mutualitity of oligation

The oft quoted case of Hall v Lorimer includes the famous and true comments:

“In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case.”

However as the Weight Watchers case demonstrates there are factors that assume a greater significance and therefore they are more often quoted.

Mutuality of obligation - the first of the factors examined is crucial as it determines whether there is a relationship in the first place and then often is a determining factor in the status. For this reason its presence is a strong factor

The second quoted factor from Ready Mixed Concrete - that of control is obviously of great importance in the Weight Watchers case. In times gone by the presence of control might well have been a determining factor in own right but the passage of time has meant that it may not be the determining factor. However the strength of control in this case clearly points to the contractual arrangement being one of employment. The level of control in the relationship in Weight watchers gets nearer to the original “master-servant “ relationship quoted in Ready Mixed Concrete. Additionally this case is one of those with the rare precedent of a major case having previously been decided on the same issues with a similar organisation that of Narich Property Ltd v Australian Commissioner of Payroll Tax, PC [1984] ICR 286. Lord Brandon held that 'a lecturer is tied hand and foot by the contract with regard to the manner in which she performs her work under it' in respect of the Australian operations of Weight Watchers.

The third of the factors that of whether factors militated against the decision based on the first two factors does not have the strength of determination in this case.

When you look at the Talentcore case only one factor is centred upon but it is a very important factor when present in its own right – the right of substitution. The right of substitution is often difficult to establish particularly where it is contained in the contract but there has been no right exercised. Proving what might be perceived as a negative is always difficult. However the report in Talentcore demonstrates the right was exercised not only in situations of emergency and illness but also in situations such that the FTT found there was an unfettered right of substitution. I have included above from the actual report instances which clearly influenced the decision of the FTT to find in favour of Talentcore.

A further aspect of the Talentcore case was the subsequent application to the Upper Tribunal by Talentcore for the costs incurred (in light of the successful determination in the Upper Tribunal of the main case). The hearing considered various aspects of the rules relating to costs and the judges comments are of interest – “I accept the submission of HMRC that some time and costs were occasioned by the application to amend to take the point under public law, which raised fundamental issues for which HMRC had to prepare. That was a distinct issue, and in principle HMRC would be entitled to some costs on that account whereas a proportion of the Respondent's costs should be disallowed on that score. It would clearly be undesirable to make cross-orders for costs and the more appropriate course is for a single discount from the Respondent's costs. Having regard also to the effect which it had on HMRC, and taking a broad brush view, I consider that the Respondent should recover 80% of its reasonable costs."

Over the years judges have referred to the lack of a list deciding factors and the weight that should be attached to each factor. Two cases dealing with aspects of the constant question appearing in close proximity firstly in the FTT and then in the Upper Tribunal demonstrate that the quest still goes and each case will still need to be decided on its own individual factors and the strength of each factor in the instant case before the relevant court. It should however be noted that if there is an unfettered right of substitution it would be very difficult for HMRC to establish an "employed" relationship (Talentcore).

Contributed by Tony Jenkins

IR35

A company (J) had been incorporated in 1994 to provide the services of its controlling director (S), who was an IT consultant. J agreed to provide S's services to a recruitment agency (H). In May 2000 H agreed to provide S's services to another company (AC), initially for six months. HMRC subsequently issued determinations that the arrangements were within the Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727), and that J was liable to pay Class 1 National Insurance Contributions on the basis that the payments it received under the contract were emoluments which it paid to S.

Decision:

The First-tier Tribunal allowed the appeal for the period from May 2000 until December 2003, but dismissed the appeal for the period from January 2004 to 2007. Judge Nowlan held that S's notional status had changed during the period, and that prior to the end of 2003, he 'would not have been regarded as an employee, but that from the start of 2004 onwards, he would have been regarded as an employee', finding that from the end of 2003 AC had regarded S 'as someone who they wished to engage and retain indefinitely'.

Comments – This case as with many IR35 cases focuses on a number of tests – In this case focusing on the feature of personal service; the degree of control; the consistency of other terms; the issue of whether the provider of services has his own business, and the slightly nebulous issue of "mutuality of undertakings".

The Tribunal examined each of these and came to the conclusion that for the first part of the relevant time he fulfilled contract status and then became an employee.

JLJ Services Limited v CRC, TC 1603

The family company meeting training costs (Lecture B692 – 10.03 minutes)

The scope is substantial, with care, and can result in a corporation tax deduction and no income tax charge on the benefit.

However, although these are hardly new opportunities there has been recent publicity of the possibilities such that attempts may well be made to restrict the potential to specific circumstances.

Payments made to employees attending full-time education courses at universities/technical colleges

Payments made by employers to employees for periods of attendance at a full-time educational course (including sandwich courses) at a recognised academic establishment are exempt from income tax and NICs where certain conditions are met.

The relevant conditions are set out in *Statement of Practice 4/86; "Payments Made By Employers To Employees When In Full-Time Attendance At Universities And Technical Colleges"*.

The full text of *Statement of Practice 4/86* is below:

"Payments made by employers to employees when in full-time attendance at universities and technical colleges (revised August 2007)

Scholarships, exhibitions, bursaries etc held by a person receiving full-time instruction at university, technical college or similar educational establishment are exempted from income tax by Section 776 ITTOIA 2005.

This Statement of Practice sets out the circumstances when payments made by an employer to an employee for periods of attendance on a full-time course (including sandwich courses) can be exempted from income tax. The following conditions and exclusion apply.

Conditions

1. *The employer requires that the employee must be enrolled at the educational establishment for at least one academic year and must attend the course for at least twenty weeks in that academic year. Or if the course is longer the employee must attend for at least twenty weeks on average, in an academic year over the period of the course.*
2. *The educational establishments must be recognised universities, technical colleges or similar educational establishments, which are open to members of the public generally and offer more than one course of practical or academic instruction. For example an employer's internal training school or one run by an employer's trade organisation will not satisfy the educational establishment condition for the Statement of Practice.*
3. *The payments, including lodging, subsistence and travelling allowances, but excluding any tuition fees payable by the employee to the university etc, do not exceed £15,480 for the 2007-08 academic year, which commences 1 September 2007.*

Exclusion

4. *This exemption does not apply to payments of earnings made for any periods spent working for the employer during vacations or otherwise.*

If the rate exceeds £15,480 HMRC may look at the arrangements in detail. This is because the level of payment exceeds what might reasonably be described as a scholarship or training allowance. However, an increase in the rate of payment over the qualifying limit, part way through a course, will not affect the exemption applying to any payments for the earlier part of the course".

Scope in using the exemption

The employee does not ordinarily have to be a full-time employee of the company prior to or after the full-time education course as EU law prohibits prejudice against part-timers. HMRC could attempt to limit the scope by imposing a minimum 25 hours per week of employment (as applies to EMI share options participation)

It should therefore be possible to use this exemption where the employee is the son or daughter of the company owner. The son or daughter should naturally work for the company during the vacation periods and be properly established as an employee before starting the education course. Continuation of the employment for a period after the course ends is also advisable – perhaps with a minimum period required which would be in accordance with normal commercial practice.

The expenditure should be tax deductible by the company as wholly and exclusively incurred for the purposes of the business, being an acceptable payment on behalf of an employee.

Work-related training

If expenditure falls under this heading it is tax deductible by the employer and exempt from an income tax charge under Section 250 ITEPA2003. If however the expenditure is met by the employee there is no income tax relief unless it is expenditure which is wholly, exclusively and necessarily incurred in the performance of the duties of the employment.

The exemption in Section 250 includes:

- costs incidental to the employee undertaking the training
- expenses incurred in connection with an examination or other assessment of what the employee has gained from the training
- the cost of obtaining any qualification, registration or award to which the employee becomes or may become entitled as a result of the training or such an examination or other assessment.

Work-related training is defined in Section 251 as a training course or other activity designed to impart, instil, improve or reinforce any knowledge, skills or personal qualities which:

- are likely to prove useful to the employee when performing the duties of the employment, or
- will qualify or better qualify the employee to perform those duties or to participate in any charitable or voluntary activities that are available to be performed in association with the employment or a related employment.

This is an extensive list of knowledge, skills or personal qualities which could be identified, and within a family company there is plenty of scope.

Contributed by Gerry Hart

CAPITAL TAXES

Part of business or part of asset used in a business? (Lecture P692 – 9.53 minutes)

Entrepreneurs' relief is structured so that several of the concepts from the obsolete retirement relief are included. This in particular ensures that relief is not available when the disposal is of part of an asset used in the business as opposed to part of the business itself.

HMRC have always attempted to take a strong line on this, with success in several well-known cases, but recently they lost an important case.

McGregor v Adcock 51TC692

- Mr Adcock sold 4.8 acres of farmland out of a total holding of 35 acres, with the sale being with planning permission for development.
- In the circumstances he carried on the same business after the disposal as before, and it was held that he had simply made a disposal of part of the business assets.

HMRC's practice seems to be to not challenge relief if the farmer disposed of over 50% of the farmland as that would have a significant impact on his subsequent activities so that a part disposal of the business had taken place. Arguably the same result should apply to a smaller %, but HMRC clearly regard this as an important issue and there is plenty of coverage in their Capital Gains Manual *paras 64015 to 64040.*

Atkinson v Dancer 61TC598

The following facts also served to deny the relief:

- Sale of freehold interest in 9 acres of land out of 89 acres used in the farming business.
- Prior to the disposal Mr Dancer had a freehold interest in 22 acres and the balance of 67 acres was held leasehold.
- He ceased egg production on the farm and a few months later sold the 9 acres – none of which was used in the egg production activity.

Mannion v Johnson 61TC598

This was also won by HMRC:

- Sale of 17 acres out of 78 held as a farmer.
- A few months later another 18 acres were sold.
- The separate disposals were held not to form part of a single transaction.

Pepper v Daffurn 66TC68

Another successful challenge by HMRC:

- Sale of 83 acres out of 113 acres farmed.
- In the particular circumstances, however, all the farmer had done was to change his activities from rearing beef cattle and sheep to that of cattle grazing. He had merely sold assets surplus to the requirements of the new activities.

Jarmin v Rawlings 67TC130

A rare loss for HMRC on this issue, although the circumstances were specific and the successful argument revolved around the disposal being that of a business:

- 64 acres of farmland owned, with a milking parlour and yard, hay barn, implements and some sheds.
- Milking parlour and yard sold plus 14 out of 34 of the dairy herd. The business was a proper dairy farming enterprise and employed a full-time worker.
- Mr Rawlings also transferred most of the remaining animals to a nearby farm owned by his wife, so ceased the milking parlour business and made the worker redundant. He retained and leased the milk quota and used the retained land to rear and finish store cattle.
- It was held that the near simultaneous actions taken by Mr Rawlings effectively combined to result in a disposal of the business even though the majority of the land was retained and put to another use. Overall, there was a disposal of the business.

Mr M Gilbert (t/a United Foods) v HMRC TC01542

This was won by the taxpayer at FTT level, and the judgement included a useful guide to the test which needs to be passed to show that the sale was of part of the business:

- Mr Gilbert was a sole trader who was a food distribution business intermediary between manufacturers and suppliers, providing goods to wholesalers.
- He charged a commission on sales and represented 9 suppliers supplying 120 customers.
- He sold part of his business to one of his suppliers, and what was sold included the customer database relating to the business plus goodwill; trademarks which he had registered relating to two brands who were among his suppliers; the benefit and burden of unperformed contracts; and the records. As a result his business turnover reduced by 55% and he could of course no longer use the trademarks.
- HMRC argued that the sale was of assets, not of part of a business.
- It was held that the correct test was to adopt a “viable section” formulation as in the IBA case of *Maco Door and Window v HMRC (2008) UKHL 54*, or use the “distinct and clearly identifiable part of the trade” test in *Bestway Holdings v HMIT 70TC512*, as opposed to HMRC’s view that the test involves “an identifiable part of the business which on its own was separately definable”

Contributed by Gerry Hart

Residence ceased?

Dr Broome was born in England in 1949. He was resident in the UK until leaving in 1977 to work in Saudi Arabia for a temporary period. He subsequently also worked in Iran and Switzerland. He visited the UK intermittently during 1978 and 1979 before returning to live and work in the UK in September 1980. When applying for income tax allowances he stated that he expected to stay in UK for two years but that he would probably not remain permanently. During this time he became ordinarily resident.

Dr Broome married in 1989. All tax returns after 1992/93 show Dr Broome's address as being 125 Valley Road, Chorleywood, Rickmansworth, Herts being the home (and principal private residence for tax purposes) of Dr Broome, his wife and their children. On 1 June 1995 Dr Broome commenced work as a self-employed consultant and submitted accounts details on UK self assessment returns.

Whilst married, Dr Broome purchased a number of properties in his own name.

46 Quickly Lane Chorleywood	purchased	18.03.1997 - [sold 20.08.2003]
78 Knaveshire Crescent, York	purchased	10.10.1997 - [sold 26.01.2001]
37a Berks Hill Chorleywood	purchased	10.07.1998 - [sold 30.05.2000]

In February 1998, Dr Broome and Mrs Broome separated and on 12 July 1999 were divorced. Thereafter, Dr Broome continued to live at 125 Valley Road, Chorleywood.

He disposed of two properties in 2000/01, but failed to declare the gains on his tax return. Following an enquiry, HMRC issued a jeopardy amendment charging tax on the gains. B appealed, contending that he had ceased to be resident in the UK after his divorce.

Decision:

In or around October 1999 Dr Broome made a decision to leave the UK and live in France. He found a property in to purchase, which he completed on 12 April 2000. He also made arrangements to either sell or let out the properties, which he owned in the UK. The precise date when Dr Broome took occupation of the property in France is unclear. However he was clearly making preparations to physically leave the UK before the beginning of the tax year commencing 5 April 2000.

The schedule of Dr Broome's visits to the UK after April 2000 show that he visited the UK on a total of 19 days in 2000/01, 27 days in 2001/02, 41 days in 2002/03, 41 days in 2003/04 and 36 days in 2004/05. Dr Broome argues that he had formed a settled intention to relinquish his UK residency during the fiscal year 1999/2000, that the evidence confirms he had become non resident by 4 April 2001, and that he remained so, despite occasional visits to the UK, for at least the following four or more years.

There is therefore a significant amount of evidence to show that Dr Broome intended to leave the UK for an indefinite period. The issue is however whether he intended to, and did in fact relinquish his UK residency before the start of the 2000/01 fiscal year. In that respect it is necessary for Dr Broome not only to have loosened his ties with the UK but also to have a settled intention in that regard [Levine v Commissions of Inland Revenue] and to have established a real and closer connection to his new country of residence [Goodwin v Curtis (1998) 70TC 478,510].

The fact that, having left the UK, Dr Broome gave 125 Valley Road, Chorleywood as his postal address in post-2000 tax returns, in his French property tax declaration, for his French bank account and for other purposes is persuasive but not conclusive evidence that he had not severed ties with the UK. However, in his tax returns he did not include a declaration, as he could have done, that the French property was his principal private residence.

Similarly, there is no evidence that Dr Broome became, or ever intended to declare to the French authorities that he had become, resident in France. He says that to do so would have resulted in him paying tax on his worldwide income, and that in any event he had decided to sell the French property not long after buying it.

Significantly, none of Dr Broome's post-2000 self assessment tax returns contained any non-residency claims. In particular, in answer to the question 9 "Are you claiming that you were not resident or not ordinarily resident or not domiciled in the UK or dual resident in the UK and another country for all or part of the year?" Dr Broome answered "No". Also, Dr Broome did not submit a completed form P85 ('Income Tax Claim when leaving the UK') until 14 July 2003.

Dr Broome was unknown to the French Revenue authorities. He did not pay any income tax in France during his stay there. If an individual is not resident in France he has no right to join the French healthcare system. To join the French healthcare system involves an open declaration of residency in France. The double taxation treaty between the UK and France (UK/France Convention for the Avoidance of Double Taxation on Taxes on Income - which came into force on 29 October 1969), effectively recognises that if an individual is resident in France, he is also domiciled there and consequently it would have been a relatively straightforward process for Dr Broome to relinquish his UK status had he wished to do so.

Physical presence in a particular place does not necessarily amount to residence [Goodwin v Curtis]. Taking into account the amount of time Dr Broome spent in France, the nature of his presence there - unconnected with any contract of employment and that there appeared to be no expectation of continuity, [Commissioners of Inland Revenue v Zorab] these facts together indicate that although living in France, he remained resident in the UK.

On a balance of probabilities there is no evidence that there was a settled purpose to the period of time Dr Broome spent in France and taking all the evidence into account it was no more than a period of transition during which for at least part of the tax year ended 4 April 2001 he remained resident in the UK.

The Tribunal therefore finds that Dr Broome was resident in the United Kingdom at some stage during the tax year ended 5 April 2000 and is by virtue of s 2 TCGA 1992 assessable to capital gains tax on the disposal of the properties, 37a Berks Hill, Chorleywood, Rickmansworth, Hertfordshire sold on 30 May 2000 and 78 Knaveshire Crescent, York sold on 26 January 2001.

The appeal is accordingly dismissed.

Dr Paul Broome

Comments – The issue of breaking residence is currently in the news following the Gaines-Cooper case in the Supreme Court. However this case together with the rationale for the decision demonstrates many of the factors that have to be taken into consideration. You will note from the Finance Bill summary that unfortunately the Statutory Residence Test has been put back to April 2013. When it is introduced it will give much needed certainty in situations such as the one illustrated above.

Capital loss created artificially

The taxpayer company, L, entered into an avoidance scheme with a bank involving finance to purchase property. It was agreed that the main objective of the arrangement was to create a capital loss, by relying on the identification rule in TCGA 1992, s 106 to match a disposal with a later acquisition. However, the company said that it also served commercial purposes.

The company claimed a capital loss which HMRC disallowed.

Decision:

The First-tier Tribunal said that the transactions in the scheme had created an artificial basis of calculating gains and losses, and the results bore no relation to the facts. On a purposive interpretation of s 106, it was clear that it was intended to apply when the taxpayer was likely to be doing something artificial, probably disposing of an asset which it intended to reacquire.

The judge, Mr Justice Nowlan, concluded that while a loss had happened, the combined application of s 106 and s 30(9) rendered the loss realised by the company to be reduced to nil.

The appeal was dismissed.

Comments – The CGT identification rules exist to deal with the complex computations necessary when one has to identify shares being disposed of. They do not exist to be used to create an artificial methodology for the avoidance of tax. Accordingly when used for such a purpose the Courts are likely to find against the taxpayer. As more legislation is introduced the methodology relies on a just and reasonable apportionment rather than a prescriptive regime which can potentially be used to advantage.

Land Securities plc TC1442

Too much too young?

In October 2009, EG died intestate. His entire estate, which had a net value of £514,600, passed to his son K, but remained unadministered. In May 2010, K died also intestate. His estate passed to his son, the second respondent, R who was three years old. The inheritance tax payable on the combined estates on K's death was approximately £89,000, but if R were to take EG's estate directly, no inheritance tax would be due. The estates of EG and K were held on statutory trust for R contingent on his attaining age 18.

R's mother E, the first claimant, did not think it appropriate that R should be entitled to income and capital as soon as he was 18 years old. She and MG, the second claimant, began proceedings under the Variation of Trusts Act 1958 for the estate to be held on trust for R contingent upon his attaining the age of 30.

Decision:

The principal issue was whether the court should consent to the suggested arrangement. Time was of the essence as the two-year deadline for the alteration of distributions under IHTA 1984, s 142 was looming. Mr Justice Norris in the High Court was not happy with the proposed new arrangement. He said it came dangerously close to the line between 'variation' and 'resettlement' and that nothing would remain of the original statutory trust. There was, furthermore, no reason to suppose that R would be incapable of dealing with any income or capital inherited from EG before he attained 30.

Finally, R had the right to have his independence and autonomy as a young adult respected, failure to do so could cause tension between him and his family. However, the judge did agree to a revised arrangement in a form which constituted a variation and not a resettlement.

Comments – The case demonstrates how important the rules are and the timing of a deed of variation can be. Often matters do not get sorted out as soon as they can be. Additionally where there is more than one death in quick succession the time can disappear even quicker. This case also demonstrates how rearrangemnt of an estate can be beneficial as the grandfather's estate enjoyed a doubled up nil band and that would be preserved if the estate went to the grandson.

Wright and another v Gater and another, Chancery Division, 7 November 2011

IHT: valuation of retained interest in income stream

An 89-year-old woman (W) created a discounted gift trust in favour of her two sons (which was a potentially exempt transfer), but retained an interest in an income stream of £4,250 each three months. She died 15 months later. HMRC issued a determination charging IHT on the basis that the value of W's retained rights was only £4,250 (i.e., one quarterly payment). Her executors appealed, contending that the retained rights should be valued at about £49,000.

Decision:

The First-tier Tribunal rejected this contention and dismissed the appeal, applying the principles in HMRC v Bower & Chesterfield (Mrs Bower's Executors) [2009] STC 510. Judge Cornwell-Kelly observed that 'the evidence adduced by the appellant shows no existing market, let alone what could be described as an open market, for the income stream to be valued, nor a market for any similar type of entitlement'.

Comments - Often with the better vision of hindsight the sum valued as retained rights appears low but the decision follows established principles. It also demonstrates the importance of checking all the details with involved with any IHT planning.

DM Watkins & CJ Harvey (Mrs KM Watkins' Executors) v HMRC TC01582

Normal gifts out of income (Lecture P693 – 23.21 minutes)

By virtue of S21 IHTA 1984, a transfer of value is an exempt transfer if, or to the extent that, it is shown that:

(i) it represented part of the transferor's normal expenditure; and

(ii) taking one year with another, it was made out of income; and

(iii) the transferor was left with sufficient income to maintain his usual standard of living.

It is up to the transferor to demonstrate that he has satisfied all three conditions in connection with any given transfer.

'Normal' is taken to mean habitual and thus requires a pattern of giving to be demonstrated. In relation to this, it can reasonably be argued that the first in a series of life assurance premium payments qualifies. Where there is initially no evidence of any regular commitment, HMRC Inheritance Tax are prepared to accept that expenditure is normal if it occurs three or more times – in such circumstances, the first two payments are also retrospectively eligible for relief. However, this view has been modified following the decision of Lightman J in the case of *Bennett v CIR (1995)*, where it was accepted that an elderly lady, whose trust income suddenly enjoyed a considerable increase following the sale by her trustees of some private company shares to a plc, could make a resolution to give the resulting additional trust income to her sons such that this resolution was a qualifying S21 IHTA 1984 gift (even though the elderly lady died just one year after executing the authority). During this 12-month period, the sons received only two payments.

In his judgment, Lightman J said:

'In my view, in the context of S21 IHTA 1984, the term "normal expenditure" connotes expenditure which at the time it took place accorded with the settled pattern of expenditure adopted by the transferor.

The existence of the settled pattern may be established in two ways. First, an examination of the expenditure by the transferor over a period of time may throw into relief a pattern, e.g. a payment each year of 10% of all income to charity or members of the individual's family or a payment of a fixed sum or a sum rising with inflation as a pension to a former employee. Second, the individual may be shown to have assumed a commitment, or adopted a firm resolution, regarding his future expenditure and thereafter complied with it. The commitment may be legal (e.g. a deed of covenant), religious (e.g. a vow to give all earnings beyond the sum needed for subsistence to those in need) or moral (e.g. to support aged parents or invalid relatives). The commitment or resolution need have none of these characteristics, but nonetheless be likewise effective as establishing a pattern, e.g. to pay the annual premiums on a life assurance qualifying policy gifted to a third party or to give a predetermined part of his income to his children.

For an expenditure to be "normal", there is no fixed minimum period during which the expenditure shall have occurred. All that is necessary is that on the totality of evidence the pattern of actual or intended regular payments shall have been established and that the item in question conforms with that pattern. If the prior commitment or resolution can be shown, a single payment implementing the commitment or resolution may be sufficient. On the other hand, if no such commitment or resolution can be shown, a series of payments may be required before the existence of the necessary pattern will emerge. The pattern need not be immutable; it must, however, be established that the pattern was intended to remain in place for more than a nominal period and indeed for a sufficient period (barring unforeseen circumstances) in order for any payment fairly to be regarded as a regular feature of the transferor's annual expenditure. Thus a "death bed" resolution to make periodic payments "for life" and a payment made in accordance with such a determination will not suffice.

The amount of the expenditure need not be fixed in amount nor need the individual recipient be the same. As regards quantum, it is sufficient that a formula or standard has been adopted by application of which the payment (which may be of a fluctuating amount) can be quantified, e.g. 10% of any earnings whatever they may be or the costs of a sick or elderly dependant's residence at a nursing home. As regards the payees, it is sufficient that their general character or the qualification for benefit is established, e.g. members of the family or needy friends.

There is no need . . . for the expenditure to be reasonable or that the expenditure is such that an ordinary person might have incurred in similar circumstances, though the existence or otherwise of this characteristic may be relevant in deciding whether the evidence establishes the necessary pattern. The fact that the objective behind the expenditure is tax planning, e.g. to prevent an accumulation of income in the hands of the transferor liable to IHT on his death, is no impediment.

What is necessary and sufficient is that the evidence should manifest the substantial conformity of each payment with an established pattern of expenditure by the individual concerned – a pattern established by proof of the existence of a prior commitment or resolution or by reference only to a sequence of payments.'

The word 'income' is not defined, although it does specifically exclude the capital element of a purchased life annuity. Nor would it include receipts of a capital nature. It is generally taken to mean the transferor's disposable income after tax and after all living expenses. In the view of HMRC Inheritance Tax, an individual's income must be determined in accordance with accountancy rather than income tax rules

One example which can commonly arise of an item taking advantage of the normal expenditure exemption is, as Lightman J points out, where a husband takes out a policy which assures his life for the benefit of his wife or children; with such a policy, the proceeds on maturity do not pass through the estate of the deceased husband whose life was assured and thus do not attract IHT but rather go directly to the wife or children who are set out in the policy as the beneficiaries. Although the capital sum in such circumstances cannot be taxed, the husband is deemed, if he pays the premium, to have made a transfer to his wife or children every time that he makes a payment; however, he will usually be able to establish that such a transfer does not represent a chargeable transfer, because it can be exempted under the normal expenditure out of income provisions. This is obviously of particular importance where the children and not the wife are the beneficiaries.

There are two further points which should be made in connection with this exemption:

(i) The exemption can be used in conjunction with the annual exemption (and not simply instead of it). Thus a transfer of £10,000 to a discretionary trust could be covered as to £4,000 by the normal expenditure exemption and as to £6,000 by the annual exemptions for the present tax year and the previous one.

(ii) The Inheritance Tax Manual makes it clear that, where there is a gift of an asset other than cash, the donor must have bought the property out of his income in order to make the gift. Note that the word 'income' refers to *current* income and so the S21 IHTA 1984 exemption will not normally apply if the gift is made from a source which, although originally income, has been retained for some time and which has therefore acquired a capital nature. If the retained income has been invested in a form which yields income, it is generally deemed to have become capital. However, the sums may remain income if they were temporarily invested in order to accumulate sufficient funds for a specific future event. Where the gift is made from a current account which includes capital receipts (from the sale of shares, for example), HMRC Inheritance Tax say that they will not normally make further enquiries in order to determine whether the gift was made from income – it is sufficient that it could have been made from income.

It should be noted that the decision in *McDowall v CIR (2004)* is relevant. A number of gifts to the taxpayer's children were made out of a deposit account which contained substantial surplus income. HMRC Inheritance Tax challenged their right to relief under S21 IHTA 1984 following the death of the donor by arguing that, when the money was transferred from a current account to the taxpayer's deposit account, it lost its character as income. This argument was rejected. The Special Commissioners concluded that the payments were made out of retained income which had remained income in character rather than capital. Their judgment contained the following sentence:

'It was identifiably money which was essentially unspent income and which had been placed on deposit but not invested in any more formal sense.'

Do not overlook the fact that clients who have surplus disposable income can make lifetime gifts of cash to settlements without incurring an entry charge.

Illustration

Alan has surplus income of at least £1,000,000 each year after his bonuses are taken into account. He therefore creates a series of discretionary trusts and pays this income into the trusts. Because Alan's transfers are exempt by virtue of S21 IHTA 1984, these gifts do not affect his cumulative lifetime total so that each settlement should have a full IHT nil rate band. It is assumed that they are not related settlements under S62 IHTA 1984.

It will be sensible to transfer no more than the current nil rate band into each trust so that no exit or 10-year anniversary charges are payable – any interest income can always be stripped out in advance of a 10-year anniversary.

Alan must not be a beneficiary of the trusts, given that the gift with reservation (GWR) rules would apply even though the initial transfer was exempt – see Para IHTM14231 of the Inheritance Tax Manual.

Perversely, HMRC insist that any such transfer must be reported on an IHT100, despite the fact that this form is only intended for *chargeable* transfers – see Para IHTM10652 of the Inheritance Tax Manual.

Note that HMRC have also reconsidered their view of what constitutes a gift 'out of income'. Para IHTM14250 of the Inheritance Tax Manual, which is new, reads as follows:

'The second condition for exemption is that the transferor should have made the gift out of their income. So a gift of capital assets such as jewellery or securities does not qualify unless it was specifically purchased by the donor from income with the intention of making the gift.

Income is not defined in IHTA 1984 but should be determined for each year in accordance with normal accountancy rules. It is not necessarily the same as income for income tax purposes. Income is the net income after payment of income tax.

It is usually clear whether payments received are income in nature. Common sources of income are employment and self-employment, rents from property, pensions, interest and dividends. But it is possible that payments received on a regular basis may appear to be income but are in fact capital in nature. An example would be receipts from a discounted gift scheme.'

The same paragraph of the Inheritance Tax Manual continues:

'Income from earlier years does not retain its character as income indefinitely. At some point, it becomes capital but there are no hard and fast rules about when this point is. If there is no evidence to the contrary, we consider that <u>income becomes capital after a period of two years</u>. Evidence to the contrary could impact either way as income:

(i) may immediately be invested in a capital product and become capital; or
(ii) may be retained as income for more than two years with a specific purpose in mind.

Each case will depend on its own facts but, in general, the longer the period of accumulation, the more likely it is that the income has become capital. However, this is not the only factor to consider. You will also need to look at how the accumulation has been made and the transferor's actions (or inaction) in accumulating it.

Often the taxpayer will try and claim that the exemption applies on gifts made out of several years of accumulated income, which you should deny. But this is a contentious area and you should seek the advice of Technical before becoming entrenched.

If a gift is made out of a current account, you only need to check that the gift could have been made out of income. You do not need to match the gift to specific money in the account.'

HMRC then deal with the problem of fluctuating income as follows:

'The intention in including "taking one year with another" in S21(1)(b) IHTA 1984 is to provide for the case where a person's income fluctuates from year to year but overall they have enough income to make normal gifts and meet their standard of living on an ongoing basis. In these cases, you may need to look at the income and expenditure over a number of years to see if the income test is satisfied. Although income can be carried over from year to year in these circumstances, you should refer to Technical if the taxpayer wishes to carry forward more than two years' income.

If there is a permanent change in the transferor's level of income or expenditure, for example because they start having to pay for care home fees, you should use your judgment in accepting or refusing the exemption in full or in part for continuing regular gifts.'

It is not at all clear what HMRC's authority is for the two-year time limit referred to above. In the speaker's view, it should be resisted where the facts suggest that an income gift has been made involving events over a longer time frame.

Contributed by Robert Jamieson

ADMINISTRATION

In-year PAYE Penalties (Lecture B694 – 26.28 minutes)

In late 2011 two cases were decided in the Tribunal concerning the new in-year PAYE penalties that apply for late payment of PAYE and NIC from 2010/11.

The rules

Under Schedule 56, FA 2009 penalties will be levied where a person is late making payments of PAYE and Class 1 NIC in any tax year from 2010/11. The amount of the penalty will depend on the number of late payments (known as "defaults"), in the tax year. The first late payment of tax does not count as a default. A penalty will not be charged in respect of the first late payment, unless the payment is more than 6 months late.

Where a person makes a further 1, 2 or 3 defaults in the tax year, a penalty will be levied equal to 1% of the total amount of the defaults (ie the total amount of tax and NIC that was paid late). The amount of the penalty increases to 2% where there are a further 4, 5 or 6 defaults and to 3% if there are a further 7, 8 or 9 defaults. If the number of defaults is 10 or more, the amount of the penalty will be 4% of the total defaults.

In addition, if any amount of tax/NIC due is more than 6 months late, a further penalty of 5% of the amount outstanding will be levied. If the tax/NIC is still outstanding after 12 months from the due date, an additional 5% penalty will be levied. These penalties will apply to the first late payment of tax even though the first late payment does not count as a default.

Taxpayers who fail to make payments of tax by the due date may request that payment be deferred for a period. If HMRC agree to the deferral request (known as 'an agreed time to pay arrangement'), the taxpayer will not be charged any late payment penalties. However, if the terms of the agreement are broken, for example if the taxpayer fails to pay the amount due at the end of the deferral period, HMRC can charge the late payment penalties.

The decision to issue a penalty or the amount of the penalty payable can be appealed against by the taxpayer. Penalties will not be charged if the taxpayer has a reasonable excuse for the late payment. An insufficiency of funds is not a reasonable excuse (unless due to events outside the taxpayers control). Relying on a third party is also not a reasonable excuse, unless the taxpayer took reasonable care.

Illustration

Period to 5^{th}	PAYE unpaid at due date	Number Of Failures	Unpaid PAYE within penalty regime	Number of defaults
May	£20,000	1		0
June	£20,500	2	£20,500	1
August	£20,000	3	£20,000	2
November	£10,000	4	£10,000	3
January	£17,000	5	£17,000	4
February	£12,000	6	£12,000	5
Total			£79,500	

John has six failures but five defaults, so the default penalty rate for 5 defaults is 2%. This rate applies to the total tax unpaid for these 5 defaults, i.e. £79,500, giving a penalty of £1,590.

Dina Foods Ltd, 25 November 2011

Dina Foods Ltd (DF) is a company that supplies Mediterranean foods. It received a penalty notice from HMRC dated 13 June 2011, received by the company on 20 June 2011, stating that as it had not paid one or more of its PAYE payments for 2010/11 on time, HMRC were charging the company a penalty. The letter included a schedule of the company's monthly PAYE payments, including both tax and NICs, for the year 2010/11 and the penalty amounts, though this did not state the dates of payment. The penalty was calculated at 4% of the company's late paid PAYE and NICs due for the year (ignoring the first default) of £276,316, leading to a penalty of £10,247.61, though there is no explanation of the calculation, or even the rationale for the 4% rate, in the letter.

Dina Foods Ltd wrote to HMRC on 21 June 2011 appealing against the penalty, citing grounds including their not being formally informed about the new penalty system and the lack of any notification of the individual late payments and the consequences.

DF’s arguments centred on the lack of warning from HMRC of the build up of the penalty. They contended that this lack of warning gave the company a reasonable excuse for its failure. An unfavourable comparison was drawn with the VAT Default Surcharge system that has a system of a warning letter and escalating penalties.

DF considered that the amount of the penalty, being 4% of the PAYE due for the year, was excessive and argued that for a first offence HMRC should have levied a lower penalty. In support of this contention the company's cash flow problems were referred to: they had negotiated a time to pay arrangement with HMRC in the past but were now aware of the need to pay on time and were doing so.

HMRC took the Tribunal through the relevant legislation and addressed the issue of publicity for the new penalty regime. HMRC believed that no responsible employer, aware of their general PAYE responsibilities, could miss all of the various communications.

Findings of fact

PAYE and NIC amounts have been paid late by the company during 2010/11. HMRC's schedule shows payments made between 4 and 84 days late during 2010/11. The Tribunal was satisfied that the company habitually paid its PAYE late during 2010/11. The nature of the PAYE penalty does not mean that the number of days late of a particular payment is relevant; once a payment is a day late, it is 'on the register' for the penalty for the year.

The company was notified of HMRC's belief that they had made all 11 payments late and had time to prepare arguments and evidence that one or more of the payments was not late. The tribunal was satisfied that the PAYE and NICs payments set out in HMRC's schedule were made late.

The Tribunal considered the evidence and contentions around the introduction of the new PAYE penalties and found that HMRC publicised the late payment penalties for PAYE and NICs extensively both before and after they came into effect.

The HMRC log shows that a 'Late payment warning' was sent to Dina Foods Ltd in June 2010. On the balance of probabilities, the Tribunal found that the various notices and letter were properly issued by HMRC. The tribunal also found that Dina Foods Ltd was contacted regularly by HMRC during the year about late payment of PAYE.

Schedules compiled by HMRC showed that Dina Foods Ltd habitually made late payments of PAYE and NICs in 2008/09 and 2009/10. These schedules were not disputed and the Tribunal found that they accurately reflect the payment record of Dina Foods Ltd for those tax years.

Rationale and decision

The legislation on PAYE penalties is clear - except in the case of special circumstances, the scheme laid down by the statute gives no discretion: the rate of penalty is simply driven by the number of PAYE late payments in the tax year by the employer. A company that makes 11 late payments in the year will fall into the 4% penalty rate. What could affect the quantum of the penalty is the possibility of showing a reasonable excuse for one or more of the individual monthly late payments. A reasonable excuse will eliminate liability for the default or defaults in question.

The scheme of the PAYE legislation requires taxpayers to pay over PAYE on time. The legislation does not require HMRC to issue warnings to individual employers, though it would be expected that a responsible tax authority would issue general material about the new system.

Schedule 56 does allow HMRC some limited discretion, under paragraph 9, to allow a 'special reduction'. The Tribunal accepted that HMRC did consider this by means of their internal review process. The conclusion reached was that no special circumstances existed.

Having considered all the evidence and material the Tribunal found no special circumstances that would justify a reduced penalty. They were of the view that no reasonable employer, aware generally of its responsibilities to make timely payments of PAYE and NICs amounts due, could fail to have seen and taken note of at least some of the information published and provided by HMRC.

The Tribunal had a number of observations to make concerning the scheme of Schedule 56 as a whole, as it applies to PAYE and NICs payments. The penalty regime is based on the number of defaults over a complete tax year. There is no separate penalty for each individual default; the penalty can only be assessed once the aggregate of the late paid tax comprised in the total of the defaults for a particular tax year has been ascertained.

The Tribunal did not therefore consider that any failure on the part of HMRC to issue warnings to defaulting taxpayers, whether in respect of the imposition of penalties or the fact of late payment, is of itself capable of amounting either to a reasonable excuse or special circumstances.

The Tribunal did not consider that the levying of the penalty in this case was plainly unfair. Although the size of penalty that has rapidly accrued in the current case may seem harsh, the scheme of the legislation is in within the margin of appreciation afforded to the State in this respect. Accordingly the Tribunal found that no Convention right has been infringed.

In summary, the Tribunal found that:

(1) The penalty has been properly levied in relation to the late payment defaults of Dina Foods Ltd in the tax year 2010/11.

(2) Dina Foods Ltd does not have a reasonable excuse for any of the failures to pay PAYE and NICs amounts on time.

(3) HMRC's decision that there are no special circumstances was not flawed.

(4) The penalty was not excessive or disproportionate.

<u>Stone Manor Hotels Limited, 12 December 2011</u>

The Appellant was late in making payment of all but one of its monthly PAYE payments in respect of the year 2010-11. The amounts paid late, the due dates and the penalty amounts subsequently charged are set out in the following table:

PAYE and NIC paid late	Due Date	Penalty @ 4%
£25,024.65	19.05.2010	£0
£4,545.91	19.06.2010	£181.84
£24,434.36	19.07.2010	£977.37
£23,340.08	19.08.2010	£933.60
£26,662.62	19.09.2010	£1,066.50
£15,153.17	19.10.2010	£606.13
£18,386.86	19.11.2010	£735.47
£14,171.66	19.12.2010	£566.87
£14,946.68	19.01.2011	£597.87
£16,487.51	19.02.2011	£659.50
£Nil	19.03.2011	£0
£27,323.31	19.04.2011	£1,092.94
£210,476.81	**Totals**	**£7,418.10**

The Appellant claims to be relieved of the penalty by reason of having a reasonable excuse for the default.

The reasonable excuse it seeks to rely on is that it was suffering from a severe shortage of funds during the relevant period, attributable to events outside its control. The tribunal were informed of the detailed history of the appellants and their attempts to sell one of their hotels and the refusal of their bank (Bank of Scotland) to help and in fact made worse by the loan being recalled in full

Decision:

HMRC should not have included the 19 April 2011 payment in the penalty calculation as this was not due in the tax year 2010/11. You cannot charge a penalty on a default that happens after the tax year. The 19 April 2011 late payment should be the trigger for a warning letter in respect of 2011/12.

It was however correct in 2010/11 to ignore the 19 April 2010 payment as this arose from a period prior to the new rules taken effect. The new penalty regime applies from 6 April 2010. What this effectively means is that in 2010/11 we need only consider 11 payments.

The exclusion of the 19 April 2011 default reduces the number of defaults to 9 which is in the 3% penalty band.

The Tribunal also commented that the penalty is chargeable on the total defaults for the year and not on a line by line basis. This should not make a significance difference but it does emphasise that this penalty can only be calculated once the year is complete and the number of defaults are known.

The Tribunal then considered the reasonable excuse and after examination of the relevant bank records determined that there was only a reasonable excuse relating to one payment namely the one on 19 May 2010. There was no reasonable excuse by reference to any of the other payments as there were sufficient funds in the bank account on the relevant due dates to make payment. As the 19 May 2010 payment had a reasonable excuse it was regarded as being made “on time”. Consequently the warning letter default shifted to the 19 June 2010 default. This meant that the number of chargeable defaults reduced to 8 and no penalty was payable on the 19 June 2010 default. The rate for 8 defaults is still 3% but the £4,545.91 June default is not liable to a penalty.

Following the Dina Foods decision the Tribunal did not consider the penalty to be disproportionate and although they said it was harsh it was not “plainly unfair”. Because of the partial decision in favour of the appellant the penalty level and amount was reduced to 3%.

The penalty on the 8 defaults from July 2010 to February 2011 should have been £4,607.48.

It should be noted that in the published judgement the penalty was confirmed at £5,494.60 but this is due to a mathematical error in that they included the May and June 2010 in the revised penalty calculations!

Comment – In both cases the Tribunal have found that the PAYE penalties were adequately publicised so arguing anything to the contrary will not be a valid defence.

The Tribunals also confirm that HMRC do not have an obligation to issue regular communications regarding the implications of each late payment. Indeed the penalty is only chargeable after the year has finished so issuing communications in the year is not required. It would seem HMRC need only issue a warning letter in respect of the first late payment. It would be interesting to see whether the failure to issue a warning letter would have a bearing on the penalty chargeable.

When considering the penalties you only consider the late payments in the tax year in question. So the 19 April 2011 payment falls into 2011/12 and not 2010/11. As an exception, the payment due on 19 April 2010 will not be regarded as falling within the 2010/11 year as it relates to a period prior to the new rules taking effect on the 6 April 2010. HMRC penalty calculations for 2010/11 should be checked to ensure they exclude the 19 April 2010 and 19 April 2011 payments.

In arguing “reasonable excuse” we must look at each individual payment and ascertain whether the client had a reasonable excuse at that time. Insufficiency of funds will not be a reasonable excuse unless it arose from circumstances beyond the taxpayers control. This is likely to be the most common basis of defence but we need to consider whether these circumstances existed at the time of each default. We may be able to get one or two defaults removed on this basis which reduces the amount on which the penalty is charged and it may also reduce the rate of penalty charged.

Whilst most of the current problems are in relation to 2010/11 penalty notices we must ensure clients pay their PAYE and NIC on time throughout 2011/12 and where they are unable to do so they negotiate a time to pay arrangement with HMRC.

Dishonest tax agents – Draft legislation (Lecture P695 – 8.34 minutes)

As part of the legislation released for consultation on 6 December 2011, HMRC published draft legislation for dealing with dishonest tax agents. This is a complete re-work of the attempt in 2010 to draw up legislation to deal with “wrongdoing” which was abandoned following the consultation held in 2010.

Consultation is open until 10 February 2012. For those who wish to read the draft for themselves, it starts on page 976 of the consultation pack.

Main legislation

The introductory clause is headed “Tax agents : dishonest conduct”. The section introduced the bulk of the legislation, which will appear in a Schedule, once finalised. The legislation will commence by Treasury Order, which can introduce transitional provisions; there can also be an Order making incidental, supplemetal, consequential, transitional or saving provisions in consequence of the Schedule, so quite wide powers are delegated to secondary legislation.

The Schedule

The Schedule itself is arranged in seven Parts, as follows:

- Part 1 – who is a tax agent and what it means to engage in dishonest conduct
- Part 2 – the process for establishing whether someone is, or has engaged in dishonest conduct
- Part 3 – power for HMRC to obtain relevant documents
- Part 4 – sanctions
- Part 5 – assessment of and appeals against penalties
- Parts 6 & 7 – miscellaneous provisions and consequential amendments

Part 1 – a tax agent

A tax agent is an individual, who in the course of business assists other persons with their tax affairs. This includes advising a client in relation to tax, and acting or purporting to act as agent on behalf of the client in relation to tax. It also includes assistance with any document that is likely to be relied upon by HMRC to determine a client's tax position – including assistance with non-tax affairs if it is given in the knowledge that it will be or is likely to be used by a client in relation to his tax affairs. This extends the legislation to cover accounts preparation for tax purposes, even if the agent does not submit the tax return.

Part 1 – dishonest conduct

If in the course of acting as a tax agent the individual does something dishonest (by act or omission) with a view to bringing about a loss of tax revenue (whether or not actually incurred), he is engaging in dishonest conduct. A loss of tax revenue is defined as when clients:

- Account for less tax than required to do so by law,
- Obtain more tax relief than they are entitled to by law,
- Account for tax later than required by law, or
- Obtain tax relief earlier than they are entitled to by law.

Part 2 – issue of and appeal against conduct notice

If HMRC determines that an individual is engaged in dishonest conduct, they may notify the individual of that determination, which must state the grounds on which the determination is made. This is called a "conduct notice". Once issued and the time for appeal has passed, HMRC will have power to obtain the papers of the agent (see below). Notice must also have been given in order to charge penalties under this legislation.

The agent who receives the conduct notice has a right of appeal which must be notified in writing within 30 days, stating the grounds of appeal. The Tribunal will then make a ruling and either uphold or set aside the conduct notice. If the notice is set aside, this does not prevent a further notice being issued if more evidence emerges.

The legislation makes it an offence to destroy "material documents" once a conduct notice has been issued (for a period of four years after the date of issue); there is a possible prison sentence of up to two years for this offence.

Part 3 - Power to obtain tax agent files

Where a conduct notice has been issued and either not appealed, or the appeal has been withdrawn or upheld, HMRC can issue a notice (a "file access notice") in writing requiring the production of "relevant papers", which are :

- Tax agent's working papers
- Any other documents created, prepared, received or used by the tax agent for the purpose of or in the course of assisting clients (including former clients) with their tax affairs

This power can also be exercised where a tax agent has been convicted of an offence relating to tax that involves fraud or dishonesty (while a tax agent – but irrespective of the role in which the offence was committed). There are various provisions regarding appeal, and the mechanics of the production of documents.

Part 4 – Sanctions for dishonest conduct

Generally speaking the financial penalty for dishonest conduct is a sum of between £5,000 and £50,000, which is determined by HMRC. In determining the amount of the penalty, the officer must take into account:

- Whether the individual disclosed the dishonest conduct (using the now standard definition of telling, helping and allowing)
- Whether the disclosure was prompted or unprompted,
- The quality of the disclosure, and
- The quality of the individual's compliance with any file access notice issued in relation to that dishonest conduct.

A special reduction is possible if the fine is set at the lowest level.

Details of the individual and their dishonest conduct can be published by HMRC (as for deliberate defaulters) unless the penalty charged is £5,000 or less.

The remainder of the draft Schedule provides supplementary and consequential provisions.

Contributed by Rebecca Benneyworth

<u>Tax Agent Strategy – The next steps</u> (Lecture P694 – 8.37 minutes)

The responses and "Next steps" document produced by HMRC recently presents a picture of engagement at all levels of the profession; it is clear that accountants and tax advisers from all sizes and types of firm have contributed to the consultation, either individually or through their professional bodies. It is clear that through much of the discussion and debate about the proposals, the concern expressed by many was about the impact of potential regulation of the tax agent community. What is also heartening is that the larger firms also had concerns about the practicalities of the proposals.

HMRC has analysed the responses and highlighted next steps under the three broad headings of the consultation.

<u>Enrolment</u>

The responses are summarised as "broad support" for the proposals for agents to register with HMRC. Most of the detail highlighted in the response document outlines the concerns of multi office and larger firms.

The views of some agents that enrolment represented the "thin end of the wedge" with regard to agent regulation were not dealt with in detail, although these concerns were recognised in the way that HMRC intends to proceed. Generally speaking respondents were supportive of the data set suggested, and enrolment on a "roll out basis" avoiding December and January was the widest supported option for implementation.

Quite a number of respondents suggested that details about Professional Indemnity insurance cover should be provided at enrolment, and there were other suggestions for data collection too, but HMRC is keen not to impose a significant burden through registration, particularly on those members of professional bodies who provide this data to their body. Bank details will only be asked for if firms wish to receive client repayments. A requirement for confirmation that the tax affairs of enrolling firms are up to date has been dropped, although tax compliance of enrolled agent firms will be monitored as part of the agent view. Firms will still be required to provide a UTR for the firm – primarily for HMRC to identify that the firm has a tax presence in the UK.

Next steps

HMRC will continue to consult with agents on the best way of rolling out enrolment, particularly with multi office firms, as enrolment of the firm rather than individual offices or staff members is intended.

In late spring 2012 a pilot test will be run with volunteer firms, using data already held by HMRC to make the initial enrolment simpler. The professional bodies have now issued a call for volunteer firms of all sizes to assist with the pilot, so that the enrolment process can be designed appropriately, taking the needs of all firms – from sole practitioners to multi office large firms. Once a suitable process has been established and tested, this will be rolled out, but most of the detailed design work will take place through the working groups with volunteer firms.

Self serve

Where responses were positive, they welcomed self serve and considered the offering as appropriate, but quite a number of respondents did not consider that self serve was sufficiently attractive to compensate for the proposals under Agent view, which were likened to regulation of the profession. There was most support for the ability to self-authorise, but many respondents were concerned that the ability to change data on HMRC's computer system would introduce additional risks and would not be widely used by them. Quite a number of respondents considered that a "view only" facility would be most useful, but would not go further than this. The most supportive respondents considered that the time savings through self serve would be considerable, and were keen to make full use of any developments as and when they become available.

There was considerable concern expressed about HMRC's ability to deliver on some of the promises for self serve, and the view expressed was that a small initial offering would be most appropriate, so that agents can gain confidence through using it, and additional functionality could then be developed. This was accepted by HMRC, who clearly see this development as a long term project.

Next steps

HMRC will begin work with the professional bodies to assemble a range of case study data based on similar implementations around the world, to establish best practice and learn from others' experiences.

During 2012 they will also work with volunteer agents on a real time study on the design and testing of new systems. By 2013 it is planned that the initial range of options for self serve, which will include agent self-authorisation and view only access to more client data will have been finalised and staged roll out will commence.

More functionality is planned afterwards, but the emphasis is on introducing robust systems steadily, which will build agents' confidence and improve take up.

Further options for the type and nature of self serve access will be considered as the project progresses, so there is no "fixed" commitment to what are the priority areas – although from HMRC's view coding notices is a key area as this generates significant contact with agents.

Agent view

The proposals for the agent view – regarded by many as a worrying development were less well received and almost all respondents were concerned that the proposals presented risks to the independence of the profession.

There was wide (pretty much universal) support for independent input into any sanctions proposed by HMRC, and a view expressed by members was sufficiently supported to gain mention in the executive summary – that HMRC should improve its own service standards before seeking to regulate tax agents.

The view in the round was that there should be room in the tax agent community for those who are members of professional bodies and those who are qualified by experience, which is what HMRC proposed initially.

Next steps

HMRC has decided to proceed more slowly with this aspect of the agent strategy, which is extremely welcome, given how controversial it has proved.

The first step will be to create a model of what data is held about agents and their clients within HMRC. HMRC would then consult further on how this data set might be interpreted, and working with agent representatives would develop a set of standards based on this data; these standards would be agreed with agent representatives. It does appear, therefore, that the "measurement" system to be applied to agents will be transparent.

HMRC will also consult further in 2012 on standards, oversight of the professional community, and independent input into any sanctions proposed by HMRC. The tax authority is particularly keen on establishing what type of independent oversight might be appropriate to use when sanctions are proposed against agents.

What to do next

The professional bodies will be seeking volunteer agents for much of this work during 2012, and many firms have already put themselves forward, which is excellent news, as the more direct involvement there is with the agent community, the better the outcomes will be. You may wish to be involved, or to read the document and proposals in full – see
http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_031777

Contributed by Rebecca Benneyworth

Costs awarded to HMRC

Following an unsuccessful appeal before the First-tier Tribunal where Innocent claimed that its smoothies were not beverages and should be zero rated, HMRC applied for costs. They did this on the basis that the case was exceptional, was substantial and complex, involved a large sum of money and was comparable to a High Court hearing.

The appellant objected, saying that the appeal had involved a single pre-hearing review, directions which the parties had largely agreed and involved one simple question.

Decision:

The First-tier Tribunal agreed with HMRC that the appeal had been an exceptional one with tax of £27m at stake. The judge noted that junior and leading counsel had been called, along with an expert witness, and that these were the kind of resources that would be expected in a High Court case.

HMRC's application for costs was allowed.

Comments – This case demonstates the importance not only of establishing the grounds for appeal but also the importance of proper consideration relating to costs. The appellants attempted to rely on the so-called Sheldon statement in 1978 that " the Commissioners [i.e. HM Customs & Excise] have concluded that, as a general rule, they should continue their policy of not seeking costs against unsuccessful appellants; however, they will ask for costs in certain cases so as to provide protection for public funds and the general body of taxpayers. For instance, they will seek costs at those exceptional tribunal hearings of substantial and complex cases where large sums are involved and which are comparable with High Court cases, unless the appeal involves an important point of law requiring clarification". New rules of course apply in respect of cases commenced under the new Tribunal structure.

Innocent Ltd (No 2) TC1450

Supposition is not enough

The taxpayer, who had been self-employed, worked for the same employer from March 2009 and throughout 2009/10. He completed his 2008/09 self assessment tax return online, and received a notice to file a 2009/10 return in April 2010. He ignored this, assuming it was a mistake because he was now employed.

In February 2011, he received a penalty notice of £100 from HMRC. He contacted the department and, as a result, HMRC issued a paper copy of the return, which the taxpayer submitted within seven days. It subsequently transpired that the taxpayer had underpaid tax of £155.40 because the employer had used the wrong PAYE code.

The taxpayer said that when he spoke to HMRC they told him that as long as he completed the paper return within 14 days, the penalty would not apply. HMRC had no record of the call, but said that the HMRC adviser would have advised that the penalty would be capped at nil, provided no further tax liability arose.

Decision:

The First-tier Tribunal judge agreed with HMRC that the taxpayer did not have a reasonable excuse for late submission of the return as he had ignored the notice to file. Such behaviour was not that of a responsible taxpayer. However, she went on to say that the case did not turn on reasonable excuse, but on HMRC's exercise of their statutory powers.

HMRC are authorised under TMA 1970, s 102 to discharge or reduce a penalty. They did not say that their call centre staff did not have the authority to do this, instead they said that no such promise 'would' have been made. The judge accepted the taxpayer's report of his call to HMRC in which they said the penalty would be discharged if the taxpayer met the 14-day deadline, which he did.

It therefore appeared to the tribunal that no penalty has been incurred by the taxpayer, because it was discharged by HMRC under their statutory powers. The taxpayer's appeal was allowed.

Comments – In this case the taxpayer was appealing against the relatively insignificant £100 penalty and clearly did not have a reasonable excuse but when advised by HMRC of a course of action to follow had the forethought to record the statements and this was successful in his appeal.

D Archer (TC1554)

Question of power

The taxpayer company was registered for gross payment status under the construction industry scheme. During 2009, it experienced cashflow problems and, as a result, made some of its monthly tax and National Insurance payments late. HMRC decided to cancel the company's gross payment status under FA 2004, s 66(1) after the April 2009 payment was made 35 days late. The company appealed.

Decision:

The First-tier Tribunal decided there was no reasonable excuse for late payment in question. The company's overdraft facility would not have been exceeded had the payment been made. Furthermore, the cashflow difficulties were not an excuse. These had been a problem for some time, and the firm should have been able to find ways of dealing with them.

However, the tribunal noted that s 66 said HMRC 'may' make a determination cancelling a taxpayer's gross payment status registration if one of the conditions in s 66(1) was satisfied. It was also clear from the legislation in s 67(4), that the court had the power to review any relevant decision of HMRC made in relation to s 66. The tribunal concluded that HMRC had not exercised their power under s 66 properly. Although they were entitled to withdraw registration, the decision was void.

The taxpayer's appeal was allowed.

Comments – Gross payment status is a major benefit to a business operating in the Construction Industry. Therefore advisers of such businesses need to be aware of the importance of defences to the potential loss of this benefit when payments are made late.

Cardiff Lift Company (TC1470)

Partnership confusion

Two taxpayers began trading in a partnership in December 2009. HMRC sent them a partnership return in April 2010, but the partners did not receive it. They did not file a partnership return for 2009/10 and, as a result, HMRC imposed a £100 penalty. They had filed correct individual self assessment returns for the year. The partners appealed against the penalty saying they had a reasonable excuse as they had not realised they had to file a partnership return as well as their personal returns.

Decision:

The First-tier Tribunal noted that the partners had visited their local tax office and came away believing that by completing the partnership pages of their personal tax returns, they would comply with their obligation. The judge said that in her view, the taxpayers had acted responsibly throughout, and as soon as they realised they should have completed a partnership return, did so.

The partners' appeal was allowed.

Comments – Lady Mitting as judge made it clear how important the appropriate behaviour is in respect of tax responsibilities where people are less familiar with their tax responsibilities and accordingly found that the parties did have a reasonable excuse in the circumstances. You will note that although guidance refers to what can be considered the FTT is showing more latitude on what can be considered a reasonable excuse.

Candlestick Company (TC1573)

Determination of penalties by FTT

A bank employee (V) failed to declare various items of income from his current and previous employer on his 2008/09 return. When HMRC discovered this, it imposed a penalty under FA 2007 Sch 24, at the rate of 15% of the potential lost revenue. V appealed, contending that the penalty contravened the European Convention on Human Rights.

Decision:

The First-tier Tribunal rejected this contention and dismissed the appeal. However, Judge Berner criticised HMRC's citation of Blyth v Birmingham Waterworks Co (Ex D 1856, 11 Ex 781) as an authority on the concept of 'negligence', holding that 'reliance on a 19th-century authority on negligence in a civil claim can hardly be regarded as authoritative in the context of the interpretation of a statutory provision for tax penalties enacted by the Finance Act 2007'.)

Comments - The Tribunal predictably upheld HMRC's view that penalties under FA 2007 Sch 24 do not contravene the European Convention on Human Rights. However, the interesting point in the case is that Judge Berner specifically disapproved HMRC's continued reliance on the 1856 case of Blyth v Birmingham Waterworks Company as an authority on what constitutes 'negligence'.

S Verma v HMRC TC01574

BUSINESS TAXES

Using share schemes to reward employees (Lecture B693 – 13.33 minutes)

Why use a share scheme to reward employees?

Offering an equity stake in the business can be an important and integral part of the process to attract and retain key employees. An outright transfer of shares, particularly where the shares have been acquired at an undervalue, can result in unwelcome up front income tax and possible NIC charges.

Using a share scheme, in particular one of the approved schemes to facilitate the issue of shares to employees can be a great way to provide the relevant incentives without significant income tax which could be as high as 50% and NIC exposure, where shares are readily convertible assets. In addition, the use of an approved share scheme can remove exposure under the new disguised remuneration rules. Approved schemes also provide for further protection in relation to restricted shares as elections under s431 are deemed to be made under certain circumstances. Thus the arrangements are made more effective for employers and attractive to key employees.

Effective ways to provide shares to employees

There are a number of ways shares can be issued to employees in a tax efficient manner avoiding an upfront exposure and in most cases ensuring that any growth in value is only charged to CGT where the rates are generally lower than income tax rates. These include:

- An outright transfer using an approved share scheme such as a share incentive plan (“SIP”);
- A grant of unapproved options over shares;
- A grant of options under an approved plan such as an Enterprise Management Incentive (“EMI”);
- The issue of partly paid shares

Corporation tax relief is generally available based on the amount the employee is chargeable to income tax. There are specific rules for approved options schemes where the deduction is based on the difference between exercise price and the amount paid for the shares, irrespective of the fact the employees have no income tax charge.

An outright transfer of shares under an approved scheme

The only approved scheme involving an award of free or discounted shares where there are no upfront tax or NIC charges is a Share Incentive Plan (Chapter 6 Part 7 & Sch 2 ITEPA 2003).

SIP’s are operated through a trust and the trustees hold the shares for employees until they are taken out of the plan or sold. Under the scheme employees may acquire Partnership shares in exchange for giving up part of their salary. Free shares up to a maximum of £3,000 per employee can be awarded and where Partnership shares are acquired, the SIP may also provide for employers to issue matching shares on a maximum 2 for 1 basis. The income tax and NIC position for employees shares held within the trust is as follows:

- If shares are held for more than 5 years, there will be no income tax and NIC charges.
- If held between 3 – 5 years, employees are taxed on the lower of initial value or the value at the time of withdrawal from the SIP.
- If held for less than 3 years, an amount equal to the value at the time they cease to be within the plan will be charged.

A SIP has to be open to all employees on similar terms so such plans are not ideal if to be used as an incentive to a small group of key employees. They can also be complex and costly to set up where prior approval from HMRC is required. Generally because of this they are less attractive to SME's than say an Enterprise Management Incentive (EMI) scheme.

Grant of unapproved options

Where an approved scheme cannot be used an unapproved share option scheme can still ensure an equity stake is passed to an employee. There are no individual limits imposed and the structure of the company and its activities generally has no impact on the use of the scheme. There is however an income tax and possibly NIC, on exercise based on the difference between the value at exercise less the price paid. This makes them very tax inefficient.

Grant of approved options

If the qualifying criteria are met the use of an approved scheme may avoid income tax and NIC charges. There are two schemes which are usually considered. The least popular is a Company Share Option Scheme (CSOP) and the other is an EMI which is still the best scheme for a SME.

CSOP (Chapter 8 Part 7 & Sch 4 ITEPA 2003)

If prior approval is obtained from HMRC, options over a maximum of shares equal in value to £30,000 can be granted. There is no limit on the number of employees who can use the scheme and it can be used for a group of key employees only. There is no restriction on the activities of the company which usually makes them more flexible to use than an EMI.

Providing the conditions are met, generally there is no tax charge on grant and no income tax or NIC if the exercise occurs between 3 and 10 years after grant. CGT is payable only at the time of disposal.

Both full and part time employees and full time directors can participate but those holding a material interest cannot participate (more than 25% of shares or assets on a winding up)

The scheme can be complex and expensive to set up and because of the low limit of allowable options and the 3 year exercise date, a CSOP is only generally considered where an EMI cannot be used.

EMI (Part 9 Chapter 7 & Sch 5 ITEPA 2003)

A scheme specifically aimed at SME's to help attract and retain key employees. The main features are:

- They must be offered by independent trading companies with gross assets not exceeding £30m. Maximum number of employees is 250.
- The company must conduct a trade on a commercial basis which does not consist wholly or mainly of excluded activities contained in Para 16 Sch 5 ITEPA 2003.
- No prior approval needed but HMRC must be notified of grant within 92 days.
- Options granted over shares with total value of £3m.
- EMI can be used to provide options on a discretionary basis with an individual grant limit of £120,000 per employee.
- Employees have to work 25 hours a week or 75% of their working time and must hold a material interest.
- No income tax or NIC at grant.
- If exercise price is equal to the market value at the date of grant, there is no income tax or NIC charged at exercise.
- HMRC will generally agree share values prior to grant.

- Individual EMI agreements can be written including specific performance criteria.
- Low set up and maintenance costs.

An EMI is a very flexible and straightforward arrangement which provides tailor made options over shares for key employees. Income tax benefits are preserved even if options are exercised immediately after grant but the option must be capable of being exercised within 10 years and the exclusions for certain trades mean that the use of an EMI is restricted.

Partly paid shares

Where an approved scheme cannot be used the use of partly paid shares is another way of providing shares to an employee without exposure to up-front income tax charges.

Under this arrangement, beneficial interest in a new issue of shares passes to the employee on the understanding the employee will pay full value but part of the share capital is left uncalled.

This uncalled amount will be treated as a notional loan under Chapter 3c and the employee could be taxable on this loan as a benefit in kind. Class IA NIC would be payable by the employer. However, both these charges can be avoided where assuming interest had been paid on a loan to acquire the shares, relief would have allowed under what are now the provisions of s392 ITA 2007 (loan to buy interest in close company).

As the share capital is uncalled, the company is not exposed to a charge under the loans to participators provisions. However, as the shares are not fully paid up no corporation tax relief will be due for the issue of shares.

The employee would have a real share with entitlement to dividends and eligibility to entrepreneurs' relief where applicable. There is a commercial risk for the employee in the event the company runs into difficulty and ultimately goes into liquidation. Under such circumstances, the employee may be obliged to pay any uncalled amounts.

Contributed by Paul Howard, Gabelle LLP

Financial intermediary

A company (C) carried on business as a financial intermediary. It received £25,000,000 from a life insurance company in return for entering into an exclusivity agreement. In its corporation tax return, it treated this £25,000,000 as a capital receipt. HMRC issued an amendment charging corporation tax on the basis that it was a trading receipt. C appealed. The First-tier Tribunal dismissed the appeal, holding on the evidence that C had not disposed of 'anything in the nature of a capital asset'.

Decision:

The Upper Tribunal upheld this decision. The disputed payment was 'income earned by the appellant from use of its goodwill, not a capital sum received by it in return for giving up any part of its goodwill'.

Comments – The distinction between capital and revenue is often fundamental to the tax treatment of the income or expenditure. At first sight, many people might assume that a payment of £25,000,000 would be capital rather than revenue. However the established case law on the distinction between capital and income remains relevant. The First-tier Tribunal reviewed the evidence and found that the appellant company had not disposed of any capital asset. Accordingly the receipt of £25,000,000 was a trading receipt rather than a capital receipt, and was chargeable to corporation tax accordingly.

Countrywide Estate Agents FS Ltd v HMRC (Upper Tribunal)

CIOT says replacement for ESC 16 is still too little

A government announcement on the tax treatment of distributions to shareholders when a small company is dissolved still needs to be modified to be good news for owners of and investors in small businesses, says the Chartered Institute of Taxation (CIOT). The CIOT believes the proposal is still too restrictive as currently drafted.

HM Revenue and Customs (HMRC) had originally proposed that legislating the existing Extra-Statutory Concession (ESC) C16 be restricted to total distributions of no more than £4,000. Following representations from the CIOT and others the proposed ceiling has been increased to £25,000, but this is still a low figure, especially where there is more than one shareholder. The concession that this legislation was designed to replace had no limit.

Andrew Gotch, Chairman of the CIOT's Owner Managed Business Sub-Committee, met with HMRC during consultation on the proposal, to argue for the ceiling to be increased. Commenting on this week's announcement he said:

"This is slightly better than the original proposals for small company shareholders but there is still plenty of room to improve the legislation further.

"HMRC's announcement of a higher ceiling is a step in the right direction. £4,000 would have been a ridiculously low level which would have rendered the legislated concession barely worth having. £25,000 is an improvement, but we would have liked to have seen a higher limit calculated per shareholder, or indeed no limit at all. The Government's argument is that a low limit is needed for anti-avoidance purposes, but we have been offered no evidence that this concession has been abused. I hope the Government will consider a further increase to, or removal of, the ceiling during this proposal's legislative passage so that the new law genuinely reflects the original concession."

Andrew Gotch explained why the measure is necessary:

"When a solvent company ceases trading and there are assets to be divided up among shareholders it is right that distributions are treated fairly for tax purposes.

"The formal winding up process, using a liquidator, can be costly and protracted. For a small company with straightforward affairs, the alternative of distributing the company's remaining assets to shareholders once creditors have been paid and then applying for the company to be struck off the Register of Companies, is attractive, cost effective and efficient. In particular, it is in keeping with the Government's objective of simplifying the tax system for small businesses and reducing unnecessary burdens.

"HMRC have traditionally recognised this in the past through an 'extra-statutory concession' which allowed them to treat the distributions the same provided their position, and that of creditors, is protected. Putting this concession on the statute books is a welcome move, especially given the House of Lords' challenge a few years ago to the extent of HMRC's discretion in areas like this: but it is important that the spirit of the concession is replicated in the legislation that is designed to replace it"

Defeat is largely irrelevant

In August 2002, the UK notified the European Commission of Gibraltar's proposed reform of corporate tax. The former tax system was to be repealed and three taxes, i.e. a companies registration fee, a payroll tax and a business property occupation tax (BPOT), were to be applied to all Gibraltar companies.

In 2004, the commission decided that the proposals constituted state aid. It also found that the reform was regionally selective since companies in Gibraltar would be taxed, in general, at a lower rate than those in the UK.

In December 2008, the EU's General Court annulled the commission's decision. The European Commission and Spain therefore appealed to the European Court of Justice. It judged that the General Court erred in law in finding that the proposed tax reform did not confer selective advantages on offshore companies.

The court said that a different tax burden resulting from the application of a 'general' tax regime was not sufficient on its own to establish the selectivity of taxation. However, it said that such selectivity existed where the criteria for assessment adopted by a tax system singled out certain entities as a privileged category.

The court found that the way that the payroll tax and BPOT would operate meant that offshore companies, since they have no employees and do not occupy business property, would not be subject to tax. This was not a random consequence of the regime, but the inevitable consequence of the fact that both corporate taxes had been designed so that offshore companies would avoid taxation.

It is worth noting that the judgment concerned a system that Gibraltar never implemented. It does not relate to Gibraltar's current corporate tax system which was implemented in July 2010 and imposed corporation tax at 10%.

The Gibraltar government said the ruling confirmed its right to decide its own tax system and rates. Chief Minister Peter Caruana said the judgment confirmed 'that the principle of regional selectivity does not apply to disentitle us from having a different and more favourable tax regime than the UK, of which we are not a region. This is the crucial issue for Gibraltar'.

EU Commission v Govt of Gibraltar & UK (Joined cases C-106/09 P; C-107/09 P)

VAT

VAT Gaming reclaims (Lecture B695 – 16.57 minutes)

The *Rank* appeal has been heard by the CJEU. The UK courts had agreed with the taxpayer that the principles of fiscal neutrality required that its games of bingo and slot machines should be treated as exempt because other, similar supplies were treated as exempt by HMRC. The UK law and practice attempted to draw a distinction between taxable and exempt supplies when they were practically indistinguishable and therefore competed against each other. The Court of Appeal (in relation to bingo) and the Upper Tribunal (in relation to slot machines) decided to refer questions on how the issue of distortion of competition should be determined.

The answers from the Court are as follows:

1. The principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for the purposes of value added tax of two supplies of services which are identical or similar from the point of view of the consumer and meet the same needs of the consumer is sufficient to establish an infringement of that principle. Such an infringement thus does not require in addition that the actual existence of competition between the services in question or distortion of competition because of such difference in treatment be established.

2. Where there is a difference in treatment of two games of chance as regards the granting of an exemption from value added tax under Article 13B(f) [6th Directive], the principle of fiscal neutrality must be interpreted as meaning that no account should be taken of the fact that those two games fall into different licensing categories and are subject to different legal regimes relating to control and regulation.

3. In order to assess whether, in the light of the principle of fiscal neutrality, two types of slot machine are similar and require the same treatment for the purposes of value added tax it must be established whether the use of those types of machine is comparable from the point of view of the average consumer and meets the same needs of that consumer, and the matters to be taken into account in that connection are, inter alia, the minimum and maximum permitted stakes and prizes and the chances of winning.

4. The principle of fiscal neutrality must be interpreted as meaning that a taxable person cannot claim reimbursement of the value added tax paid on certain supplies of services in reliance on a breach of that principle, where the tax authorities of the Member State concerned have, in practice, treated similar services as exempt supplies, although they were not exempt from value added tax under the relevant national legislation.

5. The principle of fiscal neutrality must be interpreted as meaning that a Member State which has exercised its discretion under Article 13B(f) and has exempted from value added tax the provision of all facilities for playing games of chance, while excluding from that exemption a category of machines which meet certain criteria, may not contest a claim for reimbursement of VAT based on the breach of that principle by arguing that it responded with due diligence to the development of a new type of machine not meeting those criteria.

The judgment goes through a wide range of precedents and principles, including the earlier rulings that the legality or otherwise of gambling operations, and the holding of licences or the failure to hold licences, cannot affect the VAT treatment.

The Court also points out that it is permissible for a member state to exclude certain types of gambling from exemption while retaining the exemption for others, as long as the activities are objectively dissimilar (e.g. slot machines and lotteries as opposed to horse-race betting).

The only light for HMRC is in the fourth answer. Where the UK law regarded certain comparator machines as taxable, but HMRC failed to apply the law and effectively regarded them as exempt, it is not possible for someone else who paid output tax on similar machines to claim a repayment. This is to take fiscal neutrality too far. So a person who has suffered as a result of the incorrect application of the law can claim a repayment; but where someone else has benefited from HMRC's incorrect application of the law, that person's competitors cannot insist on receiving the same benefit.

The 'due diligence defence', which was roundly rejected by the UK Tribunal, is given much shorter consideration here. It is effectively dismissed in principle by the observation that Directives have direct effect, and this does not depend on the member state deliberately or negligently failing to implement the law – so correcting a defect with due diligence cannot make any difference to that direct effect. The Court also comments that it appears that the authorities knew about the existence of the problematic types of slot machine for long enough to make a due diligence defence hard to sustain on the facts.

HMRC response

HMRC have published Revenue & Customs Brief 39/11 on 7 December 2011 in response to this decision.

Revenue & Customs Briefs 75/09 (issued 8 December 2009) and 11/10 (issued 10 March 2010) provided advice about the litigation between HM Revenue & Customs (HMRC) and the Rank Group plc considering the application of the principle of fiscal neutrality.

Following appeals by HMRC to both the Court of Appeal and the Upper Tribunal, both Courts referred questions to the Court of Justice of the European Union (CJEU) which issued its judgment on 10 November 2011.

Readership
Bingo providers and gaming machine operators.

Action required
For information only.

The CJEU judgment
The CJEU confirmed the findings of the UK courts about the interpretation of the principle of fiscal neutrality. It confirmed that similar supplies from the point of view of the consumer should be taxed in the same way and that when considering whether there has been a breach of fiscal neutrality there is no need to apply a separate 'competition' test, that is, it is not necessary to consider whether the supplies are in competition with each other. However, the CJEU also set out some tests for national courts to apply in deciding whether gaming machines are similar. In addition, it found that when determining whether there has been a breach of fiscal neutrality the actual tax treatment should be based on the legal position rather than any practice that may have been followed.

Implications
Bingo - In view of the CJEU's judgment, HMRC accept that the issue is now resolved in respect of bingo and our appeal in respect of this will be withdrawn. All valid claims received, further to Brief 75/09, have been paid, so the decision not to continue with litigation in respect of bingo means that HMRC will not be seeking any repayment of these amounts.

Gaming machines - HMRC believes that the judgment of the CJEU does not provide a final determination of the domestic litigation. Further consideration of the gaming machine appeals will now have to take place, with the parties and the domestic courts using the judgment of the CJEU for guidance. Accordingly, our appeals will continue. Brief 11/10 provided advice about claims relating to VAT accounted for on gaming machine takings between November 1998 and December 2005 and all valid claims have been paid. The judgment does not extend the findings of the UK courts to any other period, so any claims for periods prior to November 1998 and post-December 2005 will continue not to be paid

Background
The Rank Group claimed that the UK breached the principle of fiscal neutrality in respect of its taxation of gaming machines prior to December 2005 (when the legislation was changed to ensure all gaming machine takings were subject to VAT) and its taxation of certain bingo participation fees, particularly in relation to mechanised cash bingo (MCB).

The Tribunal ruled that in respect of MCB there had been a breach of fiscal neutrality because some participation fees were taxed and others were exempt from VAT and the supplies were identical. All bingo participation fees have been exempt from VAT since 2009.

The Tribunal also found that there was a breach of fiscal neutrality in respect of the tax treatment of gaming machines and similar non-gaming machines from mid-2003 and this period was extended back to November 1998 in a subsequent hearing.

The High Court supported these decisions so HMRC appealed to both the Court of Appeal and the Upper Tribunal (as the cases were at different stages) and they referred a number of questions to the CJEU.

Contributed by Mike Thexton

Reference shall be made

Grattan received a VAT repayment from HMRC which included simple interest. The company appealed, contending that under EU law, it was entitled to compound interest. The First-tier Tribunal referred the matter to the European Court of Justice. HMRC appealed against the tribunal's decision to do this. They claimed that the Court of Appeal had previously noted, in John Wilkins (Motor Engineers) Ltd v CRC [2011] STC 1371, that the interpretation of EU law and how it applied to compound interest on overpaid VAT had been settled.

Decision:

The Upper Tribunal said that the decision of any court to refer a question to the ECJ was a matter of the widest discretion for that court. The ECJ was entitled to choose not to accept the reference, but that did not in itself mean that the reference had been made incorrectly. While it was true that the question referred by the First-tier Tribunal in this instance was effectively identical to one that the Court of Appeal had declined to refer in John Wilkins, it was still entitled to refer the question to the ECJ.

HMRC's appeal was dismissed.

Comments – The question of whether compound or simple interest is paid as recompense is important**.** There has been a great deal of discussion as to whether EU law requires that interest should be compounded. The Upper Tribunal rejected HMRC's contention that, since the Littlewoods Retail case has already been referred to the ECJ, it was unnecessary to make a similar reference in the Grattan case.

Grattan plc v CRC, Upper Tribunal (Tax and Chancery Chamber), September 2011

Transfers of going concerns

The ECJ has held that Article 5(8) of the EC Sixth Directive 'must be interpreted as meaning that there is a transfer of a totality of assets, or a part thereof, for the purposes of that provision, where the stock and fittings of a retail outlet are transferred concomitantly with the conclusion of a contract of lease, to the transferee, of the premises of that outlet for an indefinite period but terminable at short notice by either party, provided that the assets transferred are sufficient for the transferee to be able to carry on an independent economic activity on a lasting basis'.

Comments - Article 5(8) of the EC Sixth Directive provided that Member States may treat the transfer of a 'totality of assets' as a succession not giving rise to a VAT liability. (This is an anti-avoidance provision preventing the purchaser from reclaiming input tax in a case where the vendor might have retired with the proceeds to a jurisdiction outside the EU.) The ECJ held that Article 5(8) applied to the scenario referred by the national court.

Finanzamt Lüdenscheid v Schriever (ECJ Case C-444/10),

Services of intermediaries: place of supply

A Scottish company (F) was formed to provide guidance and advice to students pursuing sports scholarships in the USA. Initially HMRC accepted that, for VAT purposes, its supplies should be treated as taking place in the USA, and as outside the scope of UK VAT. However, subsequently HMRC issued a ruling that the place of supply was in the UK, where F was incorporated and where its clients lived. F appealed, contending that it was an intermediary and that its supplies fell within VATA 1994 Sch 4A para 10, so that its supplies should be 'treated as made in the same country as the supply to which it relates', which was the USA.

Decision:

The First-tier Tribunal accepted this contention and allowed the appeal, holding that F's supplies were within para 10(2), since they were 'made to people who are not relevant business people consisting of activities intended to facilitate the making of other supplies' (ie, supplies of education made by US colleges in the USA).

Comments - The Tribunal held that the effect of VATA 1994 Sch 4A para 10 was that the company's supplies were treated as taking place in the USA, so that it was not required to account for UK VAT.

Firstpoint (Europe) Ltd v HMRC TC01545

Whether construction zero-rated

A woman (S) bought a plot of land adjacent to her existing house. She wanted to build two semi-detached houses (one for each of her daughters), but the local council refused planning permission for this. The council subsequently agreed to grant planning permission for the construction of a bungalow 'to provide two residential units for two related families', subject to a covenant that the bungalow would only be occupied by S and her family. The planning permission showed an internal door between the units, but the doorway was subsequently blocked up and plastered over. S claimed a refund of VAT under VATA 1994 s 35. HMRC rejected the claim on the grounds that the work failed to meet the requirements of VATA 1994 Sch 8 Group 5 Note 2.

Decision:

The Tribunal dismissed S's appeal against this decision. Judge Mosedale observed that the building had not been 'constructed entirely in accordance with the planning consent', so the conditions of Note 2(d) were not satisfied.

Comments - VATA 1994 Sch 8 Group 5 Note 2(d) provides that the construction of a building 'designed as a dwelling' only qualifies for zero-rating if 'statutory planning consent has been granted in respect of that dwelling and its construction or conversion has been carried out in accordance with that consent'. The Tribunal upheld HMRC's view that the effect of this provision was that the work done here failed to qualify for zero-rating.

Mrs SA Searle v HMRC TC01521

Supplies of photobooks

A company (H) supplied various types of 'photobooks', produced by processing digital photographs. Initially it accounted for VAT on its supplies, but subsequently it submitted a repayment claim on the basis that it was making supplies of books or booklets which qualified for zero-rating. HMRC rejected the claim on the basis that H was making supplies of photographic services which did not qualify for zero-rating. H appealed.

Decision:

The First-tier Tribunal allowed the appeal in part. Judge Berner held that 'looking at the objective characteristics of the supplies that (H) makes, the principal supply is clearly that of the photobooks themselves, a supply of goods. The services that surround that supply, including the making available of the production process, are ancillary to the supply of the goods. Those supplies are so closely linked that, viewed objectively, they form a single, indivisible supply, and that is, in this case, a supply of goods. On the evidence, most of H's 'photobooks' qualified for zero-rating, but two types of 'photobook' failed to qualify on the basis that they did not 'satisfy the minimum characteristics for the external appearance of a book or booklet', and that their leaves had 'the quality and appearance of individual photographic prints, and not pages of a book'.

Comments - The Tribunal held that the company was supplying goods rather than photographic services, and also held that most of its supplies qualified for zero-rating. Judge Berner specifically declined to follow three earlier cases concerning photograph albums, in which the Manchester VAT Tribunal had reached a different conclusion: see Draper (VTD 1107), Risbey's Photography Ltd (VTD 20783) and Digital Albums Ltd (VTD 20783).

Harrier Llc v HMRC TC01562