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PERSONAL TAX

Revised interpretation of pension carry forward rules **(Lecture P696 – 13.15 minutes)**

The annual allowance sets out the maximum amount of pension input that may be made by or in respect of an individual to registered pension schemes in a tax year without resulting in a tax charge.

From tax year 2011/12, the government reduced the annual allowance from £255,000 to £50,000. To help address the concerns, particularly of members of defined benefit schemes who may be adversely affected by this change, it also introduced new carry forward rules.

These rules permit unused annual allowance to be carried forward for up to three tax years. Special rules apply to tax years 2008/09, 2009/10 and 2010/11 where the maximum annual allowance in those years is deemed to be £50,000 for this purpose.

Where an individual's pension input in the current tax year is at least £50,000, he can then take advantage of carry forward from the three immediately preceding tax years.

HMRC recently announced that there has been a change in the interpretation of how the carry forward rules will operate in respect of the transitional tax years 2008/09 to 2010/11.

This new interpretation should be used for all carry forward calculations in respect of the transitional years and has retrospective effect from 6 April 2011.

Set out below is HMRC's original interpretation of the carry forward rules and the new 25 November 2011 interpretation.

Old interpretation

Before an individual can use the carry forward rules, first he has to use up his current tax year's annual allowance.

He can then take advantage of any unused allowance in respect of the three immediately preceding tax years.

The unused allowance is absorbed from the earliest tax year first. The example Angela – Old interpretation demonstrates how this works.

The maximum amount that Angela can carry forward to tax year 2011/12 is £8,000. This is because, although she had £10,000 available unused annual allowance for 2008/09, this is more than used up in tax year 2009/10.

The pension input of £70,000 in tax year 2009/10 exceeded the deemed £50,000 annual allowance for that tax year, so the £10,000 2008/09 carried forward annual allowance is set against the excess £20,000.

Therefore she is only able to carry forward the unused annual allowance of £8,000 for tax year 2010/11.

Note that although the carried forward calculation for tax year 2009/10 would in theory have produced a negative number, i.e. £50,000 + £10,000 – £70,000 = –£10,000, this is ignored and the carried forward amount will still be nil: carry forward calculations cannot produce negative sums.

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New interpretation

HMRC now believe that the carry forward rules operate differently where the carry forward is in respect of the three transitional carry forward tax years of 2008/09, 2009/10 and 2010/11.

In these cases each year will be assessed on its own and any unused annual allowance will not be set against pension input in excess of the allowance in a subsequent carry forward tax year.

Thus in 2011/12 the available carry forward will always be the sum of the carry forward amounts generated in the preceding three tax years.

Using the same example, the HMRC view is that the carry forward position is now as shown in Angela: New interpretation.

Under this new interpretation the maximum Angela can carry forward to tax year 2011/12 increases to £18,000: the unused annual allowance from tax years 2008/09 and 2010/11.

The unused allowance from 2008/09 is retained and is not set against the £70,000 pension input in 2009/10.

The original rules, as set out above under HMRC's pre-25 November interpretation, will continue to apply for any carry forward of unused annual allowance for tax years after the transitional years.

While this change is to be welcomed as it will increase the available carry forward for some individuals, it is a great pity that it has only now been highlighted by HMRC, almost eight months after the carry forward rules were introduced and nearly a year since the first legislation was issued in draft.

Angela - Old interpretation				
Tax Year	Pension Input	Calculation	Carried forward	Total carried forward
2008/09	40,000	50,000-40,000	10,000	10,000
2009/10	70,000	50,000 +10,000-70,000	NIL	NIL
2010/11	42,000	50,000-42,000	8,000	8,000
Angela - New interpretation				
2008/09	£40,000	50,000-40,000	10,000	10,000
2009/10	£70,000	50,000 -70,000	NIL	10,000
2010/11	£42,000	50,000-42,000	8,000	18,000

Extract from article in Taxation (5 Jan 2012) by John Woolley and John Page

New pension planning opportunity (Lecture P696 – 13.15 minutes)

As a result of the new interpretation of the rules for the carry forward discussed in the previous article, it is important that we flag up for clients, where relevant, that clients:

- may be entitled to more relief tax relief than they had previously thought.
- need to act quickly as unused relief relating to 2008/09 must be used by 5 April 2012, otherwise it is lost.

Remember to be able to access their unused relief from 2008/09, they must make contributions in 2011/12 to use up their 2011/12 annual allowance of £50,000 plus additional contributions to cover the unused relief from 2008/09.

Example 1

Jack is self-employed and has profits of £200,000. He has made the following contributions to his registered pension scheme:

2008/09	£10,000
2009/10	£70,000
2010/11	£70,000

Under the new interpretation of the carry forward rules, he has unused relief of £40,000 relating to 2008/09. This does not get set against the excess contributions in 2009/10 and 2010/11. It can be carried forward in isolation to 2011/12 but if it is not used in 2011/12, it will be lost as the carry forward is for 3 years only.

To ensure that this unused relief is used, Jack must make a contribution of £90,000 by 5 April 2012; the first £50,000 uses his 2011/12 allowance and then the balance uses up his relief brought forward from 2008/09.

With profits of £200,000, Jack has sufficient earnings to be able to make a £90,000 contribution and by making such a contribution in 2011/12, he will obtain tax relief at a mixture of 40 and 50%.

Contributions through a corporate

The same carry forward rules apply to contributions that are made a by a company.

However, a corporate contribution is not restricted to the level of an individual's earnings or salary. HMRC have made it clear that they will not question the level of contributions paid by the company into the owner's pension scheme so a low salary/high dividend extraction policy is fine.

Example 2

Jonah makes profits through his company of £200,000 per annum. He follows a low salary, high dividend route to extract these profits.

His company has made contributions into his defined contribution scheme as follows:

2008/09	£10,000
2009/10	£70,000
2010/11	£70,000

As in the previous example, provided the company makes a contribution of £90,000 into Jonah's scheme by 5 April 2012, Jonah will not have an excess contribution to report on his self assessment return for 2011/12. As always the company will obtain tax relief on the £90,000 at its marginal rate.

Jonah's low salary does not cause a problem.

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Use EIS of money

In the tax year 1998–99, R had made a chargeable gain of £2,895,489, and subsequently invested the gain in S, a limited company, which had proposed to develop a business operating public houses. The investment was made in three parts. The first part was in January 2000, when R had subscribed for £1m worth of shares in S, and the second in January 2001, when R had subscribed for a further £358,805 worth of shares in S. In January 2001, S acquired two public houses for a total consideration of £1,461,000, using the money from the first and second parts. The third part was in December 2001 when R subscribed for £1,536,684 worth of shares in S. At that point S had contemplated using the funds from the sale of its shares to purchase a third public house; however, the vendor in the sale withdrew from the transaction prior to completion, and S had been unable to find a suitable alternative property. S was consequently left with the money from the sale of the third part of shares (“the Share Subscription Money”).

S used two bank accounts: an investment account and a current account. The current account was used for S's trading income and expenditure, whereas the investment account was used to keep the Share Subscription Money. Between December 2001 and December 2003, S operated at a loss, and transferred money from the investment account to the current account, to cover respectively trading losses, and capital expenditure incurred on renovation of the two existing public houses. HMRC issued a notice on S to the effect the shares relating to the Share Subscription Money were ineligible for Enterprise Investment Scheme re-investment relief, and refused to allow R the same relief on the segment of his capital gain from 1998–99 that corresponded to the Share Subscription Money. S and R appealed against that decision to the First-tier Tribunal._ Schedule 5B of the Taxation of Chargeable Gains Act 1992 provided for reliefs in relation to reinvestment in shares. Paragraph 1(2)(g) of Sch 5B provided that investment relief was available if at least 80% of the money raised by the issue of shares was employed wholly for the purposes of a qualifying business activity, not later than the time mentioned in s289(3) ICTA 1988. Section 289(3) of the 1988 Act provided that the time referred to in para 1(2)(g) of the 1992 Act was 12 months beginning with the issue of the eligible shares. Paragraph 1(2)(h) of Sch 5B and s 289(1) of the 1988 Act contained similar provisions to respectively para 1(2)(g) and s 289(3).

The First-tier Tribunal found, inter alia, the following facts: the Share Subscription Money had been deposited in S's accounts on 18 December 2001, there had been substantial trading income deposited in S's accounts in the two-year period following 18 December 2001, S had spent £768,000 from its current account during the relevant period, and that a balance of £461,000 had been retained in S's investment account. The First-tier Tribunal held that the Share Subscription Money was not “employed” in a qualifying business activity for the purposes of the 1992 Act, and dismissed S and R's appeal. In reaching its decision the First-tier Tribunal rejected an argument by S and R that every expenditure from the current account should have been treated as having come out of the Share Subscription Money as opposed to other business income deposits, and that the money retained in S's investment account should have been treated as future planned expenditure on the business; the First-tier Tribunal held that the correct approach was to treat the Share Subscription Money as having been “employed”, inter alia, to supplement trading receipts in order to cover losses. S and R appealed to the Upper Tribunal.

Before the Upper Tribunal, S and R argued that the proper approach to analysing whether money had been “employed” for the purposes of the 1992 Act was to adopt a “first in, first out” analysis of the funds in accordance with the rule in Clayton's case; that as the Share Subscription Money had been deposited in S's accounts on 18 December 2001, i.e. before any trading receipts had been deposited, it had been “first in”, and that it should therefore have been treated as “first out” of the current account in preference to the trading receipts income, and that this analysis also have been extended to the balance of the Share Subscription Money in S's investment account, as the latter had been future planned expenditure on business activity.

Decision:

The word in "employed" in para 1(2)(g) of Sch 5B to the 1992 Act, and in s 289(1) of the 1988 Act, required money actually to be used in some way for the purposes of carrying on the qualifying activity in the relevant period; the concept extended beyond money merely being spent, but the money had to be earmarked in that period, for some specific purpose in the relevant period, and had to be kept in reserve for that purpose, though not necessarily for expenditure in that period. Whether moneys had been notionally earmarked with sufficient precision for the purposes of a qualifying activity would be a matter for assessment by a tribunal on the particular facts of an individual case. In the instant case, S had only used the Share Subscription Money to the extent the business had been making trading losses; the Share Subscription Money had therefore only been "employed" in S's qualifying activities until committed to the activity of compensating for trading losses, and the First-tier Tribunal had been entitled to find that this had only occurred when S had suffered net losses, which included taking into consideration its trading income. Furthermore, the rule in Clayton's case only provided guidance regarding allocation of payments into and out of a single account, whereas on the facts of the instant case the Share Subscription Money had been transferred between two accounts; Clayton's case did not therefore apply. The First-tier Tribunal had therefore correctly concluded that the Share Subscription Money had not been "employed" in a qualifying business activity for the purposes of the 1992 Act.

Comments – Certain legislation such as one giving various reliefs impose conditions that need to be fulfilled. The EIS legislation is a classic example as demonstrated with this case. When the law is "if at least 80% of the money raised by the issue of shares was employed wholly for the purposes of a qualifying business activity, not later than the time mentioned" it is apparent that there are a number of factors that must be observed and may need to be demonstrated. Accordingly the evidence needs to be considered to demonstrate adherence to the law rather than relying on arguing it at a later date. As was demonstrated in the case there needs to be clarity demonstrated with the use of funds to comply with the rules.

C O Richards and Skye Inns Ltd v CRC, Upper Tribunal (Tax and Chancery Chamber), 10 November 2011

Dividends taxed as earnings! (Lecture P697 – 14.07 minutes)

HMRC received an early Christmas present last year thanks to the generosity of the Court of Appeal in the case of HMRC v PA Holdings Ltd [2011] EWCA Civ 1414. This was no unwanted pair of socks either. Potentially, the decision could have unpleasant ramifications for the tax planning industry, not to mention many companies, for years to come. Coming hard on the heels of the disguised remuneration legislation, it will potentially have a significant effect on corporate remuneration strategy in future.

The arguments

In brief, the purposive interpretation of legislation by Lord Justice Moses and his two colleagues could bring the Exchequer a windfall that might extend to billions. The question that they were asked to decide was whether extremely artificial tax planning arrangements, that according to HMRC turned bonuses into dividends, should be charged to income tax and national insurance contributions as employment income or whether the planning was successful and these did constitute dividends.

There is no question that the arrangements put in place by PA Holdings on the advice of a large firm of accountants were prima facie artificial. The existing bonus arrangements for senior executives were scrapped. In their place, complicated arrangements were structured whereby these executives would be given carefully calculated numbers of shares in a new company which was to pay out dividends equal to the bonus that they would otherwise have received. It was the contention of the company and their advisers that since these payments were undoubtedly received by reason of shareholdings, they must represent dividends for both income tax and NIC purposes. The consequence of this is that a lower tax rate would be enjoyed, while NIC would not apply at all.

In both the First-tier and Upper Tribunals, it was accepted that the payments arose from employment but the judges came to the conclusion that where an amount could be taxed either as Sch E or Sch F, the old ICTA 1988 s 20(2) would provide a tiebreaker ensuring that dividend treatment overrode employment income treatment. However, they also concluded that no such tiebreaker applied for the purposes of NICs, which were due.

The decision

Lord Justice Moses made all of the running on this occasion. He has taken a highly moral line and some might argue taken purposive interpretation of legislation to new extremes. The company may not have helped itself by making a statement in its accounts leading to the First-tier Tribunal's conclusion that the objective behind the arrangements was 'to benefit those individuals as employees rather than as shareholders.'

Particularly citing the precedent in White v Franklin [1965] 1 WLR 492 Lord Justice Moses felt that the only way that one can reasonably look at this matter was:

'to consider all the facts relevant to the receipt of the income. This requires the court not to be restricted to the legal form of the source of the payment but to focus on the character of the receipt in the hands of the recipient'.

Therefore, rather than taking the approach of his colleagues in the lower courts, he decided that the only reasonable interpretation of this case was to decide that the dividends paid were not dividends but bonuses for both NIC <u>and</u> income tax purposes and that PAYE should also have been applied to them.

His final statement was pretty damning:

'In the instant appeal PA decided that its employees should receive a bonus, Mourant [the trustee] identified which of the employees, from the list provided by PA, should receive a bonus and those employees received a bonus. That, to adopt the dismissive terms of Special Commissioner de Voil in DTE [DTE Financial Services Ltd v Wilson (2001) 74 TC 14], was the beginning and end of the matter. It is, in my view, the beginning and end of these appeals'.

<u>Scenario 1</u>

Lear Ltd has three directors all of whom have 5% shareholdings. The remaining 85% are owned by 'a sleeping partner'. Each year, the majority shareholder waives his right to dividends so that very substantial sums are paid to the three director-shareholders.

In this situation, it would seem that the payments made could easily be characterised as bonuses since sums are effectively routed to directors by another shareholder.

<u>Scenario 2</u>

Much Ado Ltd has four shareholders, all of whom have 25% shareholdings. Three are directors and one is not involved in the running of the company at all. Each year, the company pays out dividends pro rata to their shareholdings.

Since dividends are paid even-handedly to those employed in the company and another, it is very hard to see how they could be treated in any way other than as dividends.

Scenario 3

Tempest Ltd has five different classes of share each designated by letters of the alphabet. The ordinary share capital is held by a number of investors. Each of the other four classes has only a single shareholder, who coincidentally is a company director.

Each year, the company pays out a dividend on ordinary shares based on profitability but only after having decided on the efficacy of performance by the four directors and declared substantial dividends based on that performance.

HMRC has long declared its distaste for alphabet share arrangements and the PA Holdings case might give it the ammunition that it has been seeking to wage war.

Scenario 4

Romeo and Juliet operate Happily Married Ltd. The company pays each of them a salary of £1,000,000 each year. In addition, it pays dividends pro rata to their 25%:75% shareholdings, which typically do not exceed £500,000 in total.

It is unlikely that an arrangement of this type would excite HMRC into trying to change the nature of the payments.

Scenario 5

A husband and wife run the highly successful Macbeth Ltd and have equal shareholdings. The company pays each of them a salary of £10,000 each year. In addition, it pays dividends equal to 95% of annual distributable profits. In recent years, these dividends have always totalled at least £1m between them.

This might be the 'don't know' situation. Dividends are certainly paid out pro rata to shareholdings and most advisers would believe that it is perfectly legitimate to limit salary and pay large dividends instead. Time will tell as to whether HMRC might have a different opinion.

Implications

To an extent, this might be seen as merely an historical whim since the underlying legislation was replaced long ago. However, there has to be every chance that missives are being fired around tax offices up and down the country encouraging Inspectors to review dividend payments to see whether they might reasonably be taxed as bonuses.

Liability

One problem for hard-pressed businesses is that in any case of this type, the liability will initially fall on the employer not the employee. The extent to which it might have the right to recover the sums could well depend on the initial paperwork but also its stomach for chasing after former employees or trying to recover sums from key members of the existing management team.

Potential consequences

There seems every reason to believe that HMRC will take delight in this decision. Assuming that the taxpayer does not appeal, it may well take the view that a large number of artificial arrangements can now be attacked in the confident knowledge that the courts are likely to uphold its long-held views.

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In particular, the use of alphabet share arrangements by which every employee of a company, or possibly just senior ones, receives dividends that replace bonuses must surely now be regarded as in danger.

Similarly, if dividends are waived by non-employee shareholders so that large sums can be paid to those working in the business in lieu of bonuses, a judge might well see this as unacceptable artificial planning with the consequence that the dividends are no longer treated as such.

Other situations may be more borderline but the taxman could just decide that with the support of the Court of Appeal, an aggressive approach might yield much-needed revenues in the current economic climate.

A number of different scenarios that are intended to follow the spirit of the decision in this case might provide food for thought for company directors up and down the country; see the shaded box.

The future

As so often, the consequence of what the man in the street would see as unacceptable tax avoidance is that many folk organising their tax affairs in what would seem to be a perfectly reasonable way now find themselves subject to great uncertainty and worry.

At the moment, it is not clear whether the taxpayer might seek to take the Court of Appeal's decision to the Supreme Court. Unless it does so, the only conclusion that one can reasonably reach is that many types of remuneration strategy involving dividends that had previously been regarded as legitimate and effective could turn out to be disasters waiting to happen.

Anyone who uses aggressive dividend planning around remuneration would be well advised to review their position at the earliest opportunity.

Extract from article in Tax Journal (20 Jan 2012) by Philip Fisher (PKF)

Notional interest payments under 'Ponzi' scheme

An individual (M) had life savings of about £140,000. An accountant (L) persuaded him to 'invest' his savings by making a series of short-term loans to a company (DL) which traded in firearms, and of which L was the managing director. DL (which subsequently went into liquidation) issued M with documents indicating that he had been credited with interest totalling £304,505 over three years, all of which had been reinvested. HMRC issued assessments charging tax on this interest, and M appealed.

Decision:

The First-tier Tribunal reviewed the evidence in detail and allowed M's appeal.

Judge Nowlan held that 'in reality, the arrangement had all the attributes of a fluctuating loan where, in cash terms, the appellant would extract nothing from the arrangements unless and until the loans could ultimately be repaid in full'. In these circumstances, it was 'appropriate to ignore the fictitious form of the individual transactions under which each loan, and each receipt of interest, was treated as a separate transaction. The realistic analysis is that the high interest was only paid to lure investors to re-advance everything transiently repaid and paid, and that the appellant should only be treated as receiving interest, after full repayment of the principal advanced. Since at no time in the cycle of loans and further loans, did the appellant ever in net terms get his £140,000 back and since, at the end of the day, he lost everything, we conclude that in realistic terms, no interest was received.' Judge Nowlan observed that it was not suggested that 'the tax liability on interest received by an individual would be eliminated merely because the interest is reinvested and subsequently lost'. However, the position might differ 'if the transactions are always part of a scam, in which

the borrower has a manifest plan, always to lure investors in to re-advance virtually everything repaid and paid under earlier transactions, particularly where in reality the borrower must know that the likelihood of being able to discharge any of the mushrooming debts at the end of the day is virtually zero'. On the evidence, L had deliberately misrepresented the potential tax liability to M, and had 'proceeded on a basis of quite improper concealment', so that 'from the very outset it was of the essence of the plan that the profits given to investors would be pure paper profits, and that invariable reinvestment was always contemplated, and indeed utterly vital'. Accordingly, it was 'appropriate to ignore the fictitious form of the individual transaction under which interest was paid in theory, but inevitably reversed by the investors being lured into reinvesting virtually everything received'. Judge Nowlan concluded that 'utterly fictitious receipts of interest, invariably matched by reinvestments, when the borrower knows that the borrower company is inevitably heading for a catastrophic collapse in which the investors will never receive any return and will probably lose everything, all in a Ponzi-style transaction, are not relevant receipts of interest for tax purposes'.

Comments - Interest remains taxable even if it is simply credited to an account without being drawn. However, Judge Nowlan held that this principle did not apply to the unusual facts here, where the appellant appeared to have been the victim of a fraudulent scheme devised by an accountant whom he trusted. Judge Nowlan's comments are self-explanatory, and the case also appears to illustrate the principle of 'caveat emptor'.

J Mazurkiewicz v HMRC (TC01643)

Interest on refund of insurance premiums

An individual (S) had purchased an insurance policy in 1994. In 2004 the insurer changed the terms of the policy. S complained to the Financial Services Authority. In 2008, following prolonged negotiations involving the Financial Ombudsman Service, the insurer agreed to refund S's premiums with interest at 8% p.a. The insurer deducted tax from the interest. S appealed to the First-tier Tribunal, contending that the whole of the repayment, including the interest, should be treated as capital.

Decision:

The Tribunal rejected this contention and dismissed the appeal.

Comments - The Tribunal upheld HMRC's view that tax had been correctly deducted from the interest. We have an instance in a month of cases dealing with similar matters – the previous case dealing with whether the interest is taxable and this one highlights the treatment of that interest for tax on the basis that it is taxable as income rtaher than as capital.

R Sutton v HMRC (TC01606)

Wholly, exclusively and necessarily incurred?

The appellant (who was a certified accountant) was employed as a manager by a firm of accountants. In her self-assessment return for the 2007–08 tax year she claimed employment deductions of £4,068 and £5,683 travel expenses, which included her costs for attending an overseas conference. She stated that all her expenses had been wholly, necessarily and exclusively incurred in the performance of the duties of her employment—within S336(1) ITEPA 2003 including P11D benefit from employer. HMRC opened an enquiry into that return.

During the course of correspondence between the parties, the appellant stated that her employer had increased her salary to cover the expenses from 1 February 2009, but they had not been deducted from her salary. She broke down her items of expenditure as follows: (i) business and travel expenses, comprising of

costs for attending an overseas conference and related expenditure, such as special clothing, travel insurance, a gift for the conference, travel insurance, and an emergency flight back to work; travel from office to clients; and dinner for client's bookkeeper and student IT help; and (ii) sundry employment costs, including rent (as part of her work was at home and she also stored disk backups for her firm at home); phone calls made from home; Companies House – annual return and research costs for clients; office expenses; Post Office and stationery etc costs.

The appellant's employer wrote to HMRC stating that there was no requirement under her contract of employment for her to attend conferences and they would only pay those costs if they could bill a client for her attendance, but they had paid for her time in attendance and that the conference had been a natural extension of her work. HMRC disallowed the claims on the basis that none of the claims for deductions qualified for relief because the decision to incur the costs was one of personal choice and was not imposed by the duties of the employment. The appellant appealed. The issue arose as to whether the expenses were allowable.

Decision:

In order for expenditure to fulfil the "wholly , exclusively and necessarily incurred" test the duties of the employment had to be such as to require the incurring of the expenditure. The test was strict and required an examination of whether the specific terms of the employment, whether written or oral, required the employee to incur the expenditure. "Incur" meant that the employee had to bear the expense. However, reimbursement did not prevent any payment by the employee from being eligible for deductibility, provided the reimbursement was included in the employee's earnings, as provided in S334 ITEPA. The requirements in respect of travel expenses were similar: s 337(1)(a) corresponded to s 336(1)(a), and 337(1)(b) required that the expenses were necessarily incurred "on travelling in the performance of the duties of the employment". In this case, the conference costs were not allowable as they did not meet either the test in s 336(1)(a) or sub-s (1)(b). It followed that various associated expenses relating to the conference were to be disallowed as the travel costs, including travel insurance and the emergency back to work flight, did not meet the similar tests in s 337(1)(a) and (b).

Furthermore, although there might be circumstances in which specialised clothing provided by an employee might meet the "wholly, exclusively and necessarily" test, the form of clothing would have to be both extremely specialised and for all practical purposes unusable, and unused, outside work. Any clothing the appellant purchased for the conference could not possibly fall within such an exceptional category. There was no evidence to justify any further travel expenses. The gift for conference did not meet the tests in ss 336 or 356, and the costs for the dinner were disallowed under s 356. In relation to the other employment sundry costs, there was no evidence that keeping an office at her home was a requirement of her employment, or that she was required by the terms of her employer to incur the expense of any telephone calls, and her claims for those items would be disallowed. As the claims for fees paid to Companies House related to clients, they were incurred wholly, necessarily and exclusively in the performance of her duties. However, the remaining claims—office expenses etc—were not allowable against her income as there was no evidence she was required to incur them. Thus, with the exception of the Companies House costs, none of her expenses were allowable.

Where an employer granted a salary increase to an employee to cover expenses, that informal method of reimbursement did not of itself result in an expense becoming allowable. S334 ITEPA provided that a person, ie the employee, might be regarded as paying an amount despite its reimbursement, although an allowance could only be made under Ch 5 if and to the extent that the reimbursement or other payment was included in the employee's earnings. As the appellant had not satisfied the conditions in those sections relevant to her claims, the question of reimbursement did not determine the issue. The appeal would be dismissed, save for the claim for payments to Companies House.

Comments - s336 ITEPA 2003 provides that a deduction is only allowable where expenditure 'is incurred wholly, exclusively and necessarily in the performance of the duties of the employment'. This of course contrasts with the equally important much less strict test of “wholly and exclusively” as demonstrated later in these notes with two cases examining the legal expenses claimed by two taxpayers defending themselves. It is somewhat surprising to see an accountant involved in such a case. This case is a good demonstration of the extent of the legislation and what is required to meet the extremely tight parameters.

Miss SH Ling v HMRC (TC01629)

National Insurance Contributions on disguised remuneration—FAQs

HMRC has published Frequently Asked Questions on employment income provided through third parties, known as disguised remuneration, and National Insurance contributions. They cover when and how the rules will apply to the arrangements.

Schedule 2 to the Finance Act 2011 made rules about employment income provided through third parties, to tackle arrangements used for the purposes of disguising remuneration in order to avoid or defer income tax or to circumvent the annual and lifetime allowances in registered pension schemes. These rules are chiefly found in Part 7A of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA).

Similar provision has now been made for NIC. The Social Security (Contributions) (Amendment No.5) Regs 2011 (SI 2011/2700) amended the Social Security (Contributions) Regs 2001 (SI 2001/1004), inserting new reg 22B and new para 2A of Part 10 of Schedule 3.

These FAQs will be subsumed into the National Insurance Manual in due course.

Improving the operation of PAYE—proposed P45 and P46 replacement

Following the Technical Note published on 14 November 2011 in relation to the proposed abolition of the P45 and P46 forms, HMRC has received concerns from some employers and software developers. HMRC has stated that they are working with these interested parties.

Technical Note 14 November 2011: proposal to abolish the P45/P46 forms (LNB News 14/11/2011 140)

The draft regulations for Real Time Information (RTI), published on 14 November 2011, included a proposal to abolish the P45/P46 forms when RTI is introduced. Instead, HM Revenue & Customs (HMRC) will be sent starter and leaver information when the regular RTI payroll return is sent to HMRC. The abolition of these forms is intended to make PAYE easier for employers to operate.

For the purposes of maintaining accurate in-year payments of tax across jobs, employees will instead be given a “leaver statement” by their employer giving pay and tax details that they can provide to their next employer and retain for their own records.

Some employers and software developers have expressed concern over the proposal that employees could be given a leaver statement instead of a P45. HMRC are working with interested parties to explore these concerns and seek a way forward.

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CAPITAL TAXES

EIS Interaction with Taper

An individual (S) disposed of several properties, some of which had been used for business purposes , some of which had been used partly for business purposes, and some of which had not been used for business purposes. He claimed EIS deferral relief under TCGA, Sch 5B and taper relief under TCGA, s 2A(5), and claimed that the EIS relief should be set firstly against the gains on the non-business properties and secondly against the non-business parts of the 'mixed use' properties. HMRC accepted that the relief could be set firstly against the gains on the properties that had never been used for business purposes, but issued a ruling that where a property had been used for both business and non-business purposes, the EIS relief had to be treated as diminishing a single gain (so that it was split between the business and non-business elements on a pro rata basis). S appealed.

Decision:

The First-Tier Tribunal allowed his appeal. Judge Nowlan held that it would be 'very odd for the legislation to permit EIS relief to be set against gains on chosen assets, and thus most obviously against gains on non-business assets, if then it is contended that a different rule applies where an asset is subdivided for taper relief purposes'.

Comments – Following the demise of taper relief we have seen a number of cases dealing with the principles of taper relief and how it interacted with other CGT principles and reliefs. The more commonly seen anomaly is that where taper relief interacts with the Principal Private Residence Relief and the anomaly in terms of calculation and apportionment. Judge Nowlan’s comments should be noted.

M Stolkin v HMRCTC01667

ADMINISTRATION

In-year PAYE penalties – 3rd victory for HMRC

The appellant company was late in paying its monthly PAYE and national insurance contributions (NICs) to HMRC for every month during the 2010–11 tax year. From 6 April 2010 FA 2009 Sch 56 imposed penalties for late payment of PAYE which were structured on a sliding scale; the more late payments in a tax year, the larger the percentage penalty applied to the aggregate of the late payments. HMRC accordingly imposed a penalty on the appellant at the four per cent rate, which was payable if there were ten or more defaults during the tax year. The appellant appealed.

The following issues arose for consideration, namely whether:

(i) HMRC had to consider the question of "special circumstances" in FA 2009, Sch 56, para 9 as an essential preliminary step before assessing a penalty;

(ii) it was an essential precondition to the imposition of a penalty that there was no reasonable excuse for the purposes of para 16;

(iii) the penalty was disproportionate, and the appellant relied on its financial problems and the fact that other companies who paid PAYE late had not received penalties, and

(iv) the penalty was a breach of the common law duty of fairness and HMRC were required to issue penalty notices early or reminders/warnings that penalties could be accruing.

Decision:

FA 2009 Sch 56, para 9 allowed a penalty to be reduced "if HMRC think it right because of special circumstances". There was nothing in that power to reduce which was, in the same way, fundamental to the arisal of the penalty in first place. Furthermore the use of the phrase "they may reduce a penalty" in para 9 implied that a perfectly valid penalty might exist before the question of reducing it, by reason of "special circumstances", arose; Scofield v Revenue and Customs Comrs [2011] UKFTT 199 (TC), [2011] SFTD 560 distinguished.

FA 2009 Sch 56 had to be interpreted as a whole in line with its purpose. There was nothing in the drafting or general scheme of Sch 56 which required the question of reasonable excuse to be considered before any penalty could be assessed. Indeed, para 16 specifically contemplated the First-tier Tribunal or Upper Tribunal adjudicating on whether a reasonable excuse existed and there was no mechanism set out in the schedule for how either of them might do so without a penalty having been assessed and appealed; it proceeded on the tacit assumption that the tribunal would be considering the issue of reasonable excuse in the context of an appeal against a penalty. If a tribunal found that a reasonable excuse existed, then it would be discovered, as a result of such finding, that the penalty (or the relevant part of it) never arose. Therefore there was no requirement for HMRC to consider the question of reasonable excuse as a preliminary matter before assessing a penalty.

The tribunal considered that the penalty actually imposed in the present case was not disproportionate. In addition, a general unsubstantiated assertion that HMRC were not imposing penalties even-handedly could not found a proportionality argument which was concerned with the proportion between the default and the penalty, not with that between the taxpayer's penalty and any other person's penalty.

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In relation to the breach of the common law duty of fairness argument, the appellant was really complaining that it did not realise the full implications of its action in terms of the new penalties it would attract. It was a long established principle of English law that ignorance of the law was an argument that was doomed to fail. It followed that the appeal would be dismissed; HMD Response International v Revenue and Customs Comrs [2011] UKFTT 472 (TC), [2011] SFTD 1017 distinguished.

Appeal dismissed.

Comments – Pleading ignorance or arguing against the fairness of the new penalty rules is unlikely to be successful. The taxpayer must look at each late PAYE payment and detail the factors that they feel gave them a reasonable excuse for that particular late payment.

Agar Limited v Revenue and Customs Comrs TC 1625

In-year PAYE penalties – Taxpayer wins!

The taxpayer company made nine out of 12 monthly payments due under PAYE late during the year 2010/11. As a result, HMRC issued penalties of £29,841.89 or 3% of the annual tax and National Insurance due.

The company appealed, claiming it had a reasonable excuse for its failure to pay on time. It explained that it’s trading and cash flow position was adversely affected by nine specific business failures, leading to liquidation or administration of its debtors. The bad debts were £259,315.42. It also mentioned that other customers who did pay extended their credit period and persistently paid late.

HMRC argued that the taxpayer company was a persistent offender and it did not have a reasonable excuse.

The evidence also showed that the company was having problems with its bank, which insisted on converting a £4 million overdraft facility into a confidential invoice discounting arrangement which reduced the company's working capital by around 30%. At the same time, the bank increased its charges by £32,000 a year and hiked those on all loans by 1.5%.

Decision:

The First-tier Tribunal judge, Geraint Jones QC, said there could be 'few who can be oblivious to the pressures upon small and medium-size businesses caused by the recent turbulence in the financial markets and the near recession-like conditions that have prevailed in the economy at large in the UK and perhaps Europe generally, over the last two or three years'. He had no hesitation in concluding that the company had a reasonable excuse for its tardiness in making the payments, which were in any event only paid a few days late in most cases.

He was also satisfied that the company had used reasonable diligence to pay the tax. The company was clearly doing all it could to collect its debts and renegotiate its facilities with its bankers 'on commercially acceptable terms, as swiftly as it could manage'.

Mr Jones said the company had a reasonable excuse for the late payments.

The taxpayer company's appeal was allowed.

Comments – As highlighted in the first two cases reported last month and the Agar case this month the regime set out Sch 56 is prescriptive in that no discretion is available to HMRC in respect of the penalties.

However HMRC do have the option of exercising the relief available in special circumstances and of course the ultimate appeal by the taxpayer is to the Tribunal. In this case the taxpayer was fortunate to come before Judge Geraint Jones who is establishing a record of exercising judgement leniently depending upon the circumstances.

This case demonstrates that due diligence into the reasons for late payment and background of the client's business can provide powerful evidence towards mitigating a penalty.

It needs to be remembered that clearly taking timely actions to ensure that PAYE is paid on time is preferable to being in the circumstances where one has to rely judgements in previous tribunal cases in light of them not being of precedential authority. However cases such as these are to be noted as they provide potential weapons to be used in a client's defence.

Dudman Group Ltd (TC1608)

Penalty reduced for late P35

The taxpayer company appealed against a penalty of £500 imposed by HMRC because it filed its 2009/10 end-of-year employer's PAYE return late. The company accepted that it had not filed a return, but this was due to a misunderstanding of what was required and, soon after it received the penalty, the company submitted the return.

Decision:

The First-tier Tribunal judge, Geraint Jones QC, as he has in previous similar appeals, gave a robust decision, and reduced the penalty to £100.

As well as reiterating points he has made in previous decisions, e.g. Hok Ltd (TC1286), Walton Kiddiwinks Private Day Nursery (TC1326), saying that HMRC's method of sending late penalty notices is unfair and would be recognised as such by a 'fair-minded observer', he brought the department's method of issuing VAT penalties into play: these, he noted, do not increase over time. He said:

'I am entitled to take judicial notice (based upon experience of sitting in a specialist tribunal) of the fact that where a taxpayer defaults in sending in a VAT return on time, or defaults in paying the amount of VAT due on time, a default notice or surcharge notice (whichever is appropriate) is usually sent out within 14 to 21 days. I can and do take judicial notice of that fact. In a VAT default case the penalty (if applicable) does not increase with the passage of time, by contrast to the penalty regime for failing to file an end-of-year return by the 19 May. Thus in a VAT case HMRC has no interest in delaying sending out the penalty notice (where applicable), as the penalty does not increase as time goes by. It may be, and usually is otherwise in P35 default situations.'

He went on to suggest that a 'fair-minded objective observer' might wonder if the delay in sending penalties in respect of late forms P35 was 'something done deliberately by HMRC so as to increase the penalty monies received … given that additional penalties accrue while the default continues'. He added that often the failure by an employer to file on time is a result of 'oversight or forgetfulness which, had a timeous first penalty notice been issued' would have been dealt with immediately.

Mr Jones concluded that 'the only fair and just outcome', as a result of this 'conspicuous unfairness' was to reduce the penalty to £100. The company's appeal was allowed in part.

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In another appeal, Corballon Ltd (TC1634) concerning penalties for a late filed P35, Geraint Jones QC made similar comments about HMRC's process for issuing these penalties. In that case, the company had problems obtaining an activation code from HMRC to enable it to file online.

Mr Jones was 'not persuaded, even on the balance of probabilities, that the reason for the appellant not receiving its activation code arose from any default on its part'. He decided the company had a reasonable excuse for not filing its return on time and cancelled the penalties. However, he said that even had he not found the company had reasonable excuse, he would still have reduced the penalty because of the four-month delay in issuing the penalty notice.

It should be noted that, as reported in Taxation, 17 November 2011, page 3, HMRC have appealed the Hok decision and that it is to be heard in the Upper Tribunal.

Comments - In the current business environment smaller businesses are struggling and doing their best to stay in business as well as meet their statutory obligations. This case is another demonstrating that HMRC procedures must where possible recognise that they have an obligation to ensure that penalties are fairly raised as opposed to carrying out procedures which in effect maximise the penalties because the taxpayer is not necessarily aware of the penalties or the mechanism by which they operate. It is likely that we will se more of these.

Talkabout Publishing (TC1637)

P35 was received by HMRC

The taxpayer asserted that he had submitted his employer's end-of-year return for 2009/10 on time, i.e. by 19 May 2010. HMRC claimed that it had not been received on time and imposed a late filing penalty.

Decision:

The First-tier Tribunal judge, Geraint Jones QC, said that for a penalty to be charged, HMRC have to prove that one is justified and referred to the European Court of Justice decision in Jusilla v Finland [2009] STC 29. Therefore, in this case, they had to provide evidence that the return was late. HMRC had failed to produce any such proof, relying instead on their recording system and claiming that it permitted no margin of error. The judge said he considered it inappropriate to adopt and rely on this claim.

He noted that the taxpayer's adviser had filed employers' returns for several clients and that HMRC had alleged another client's return was late. However, the adviser's computer had the electronic confirmation of receipt.

Mr Jones concluded that there was evidence that HMRC's recording system was unreliable, and that the department had not proved on the balance of probabilities that the taxpayer's return had been late. The appeal was allowed.

Comments - Another end of year return case demonstrates that are a different number of arguments that can be deployed in defence of the taxpayer client. Record keeping is essential to normal operation and proved to be invaluable in these circumstances. An advantage of regular training and keeping up to date is that one is aware of defences that have been successful in other cases. In this case the adviser knew from his own internal client base of the deficiencies of HMRC records but clearly keeping up to date gives one this extra knowledge.

H McDonald (TC1631)

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Who is responsible for submitting the P35?

The taxpayer appealed against penalties totalling £1,600 for not filing her employer's end-of-year return for 2009/10 by 19 May.

The taxpayer, a widow aged 75 years, had been in hospital in October 2009 and again in May 2010. She had sold her recruitment business in March 2010, handing over all computer records, etc. to the new owner. She explained that she believed that the new owner would have dealt with the employer's return.

HMRC claimed that they had not been informed about the change of ownership of the business until February 2011. They said further that when a company closed down, the proprietor still had to send in the form P35 on time.

Decision:

The First-tier Tribunal judge, Anne Redston, noted that it was not disputed that the business had been sold in March 2010, before the end of the 2009/10 tax year. Thus, under Income Tax (PAYE) Regulations, reg 102(4), the new employer assumed the obligations of the former employer, so it was not the taxpayer's responsibility to submit the employer's return for that year. Whether or not the new employer had in fact completed the return on time was not relevant to the appeal.

While it was true that the taxpayer had not told HMRC about the change in ownership, this was because of her illness at the time. There was, however, no penalty for failing to do this.

As the taxpayer was not the employer at the time the P35 was due to be filed, no penalties were due. The taxpayer's appeal was allowed.

Comments - Reading the facts of this relatively straightforward case, it seems obvious, under the PAYE regulations, that the taxpayer was not the person liable to submit the relevant return. It is remarkable that no one at HMRC reached this conclusion, even if they were not informed of the change until 11 months after the event, before the case got as far as a tribunal hearing. Often the most obvious defence can be the most effective.

J Harmsworth (TC1650)

Paper P35s were received by HMRC

The taxpayer in another case concerning P35s, received penalties for alleged late filed returns for 2007/08 to 2009/10. For the two earlier years, she filed her returns on paper, as she was entitled, but said that HMRC mislaid them. However, she said she was not informed that the department had not received the returns until she received a penalty notice dated 16 February 2011.

HMRC said they had no proof that the paper returns had been filed.

Decision:

The First-tier Tribunal judge, Anne Redston, found as a fact that the 2007/08 and 2008/09 returns had been sent by post on time, based on the taxpayer having complied with her responsibilities in the previous 13 years. She said under the Interpretations Act, the documents would be deemed to be delivered unless it could be proved otherwise. HMRC had not proved the returns had not been received, and had even admitted in a

phone call to the taxpayer that they had 'probably been filed incorrectly'. Thus the penalties for those years were quashed.

Turning to the 2009/10 return, the taxpayer submitted this on paper, although it should have been done online. During a phone call in October, HMRC explained to the taxpayer's agent that the return should have been filed online, but did not issue a penalty until the following February and then for £400, rather than for the full period from May.

Ms Redston decided that in light of the telephone conversation in October, the taxpayer should have been aware of her statutory obligation, therefore the penalty was proportionate.

The appeals relating to 2007/08 and 2008/09 were allowed, that for 2009/10 was dismissed.

Comments -

It might seem that appeals against penalties for late filed employers' returns are usually successful. This is not so, as each case turns on its own facts.

Jean Ross trading as Hilltop Boarding Kennels (TC1651)

Tougher procedures for civil fraud investigations

HMRC's contractual disclosure facility (CDF) is a new opportunity for taxpayers to own up to tax fraud. Coming into effect at the end of January, under the new facility HMRC will write to a taxpayer, because they suspect he has committed a tax fraud, offering a CDF contract. This will include an acceptance letter, a denial letter, a disclosure form and a copy of COP9. This facility offers the taxpayer three options: own up, deny, or not reply.

Entering into a CDF contract with HMRC means the taxpayer agrees to abide by the terms and conditions of the contract. This means that HMRC will not criminally investigate and prosecute the taxpayer over the fraud covered in that CDF contract. In return, the taxpayer must:

- tell HMRC about all the tax deliberately evaded, with no exceptions, within 60 days of being offered the contract;
- sign a statement to say that he has provided accurate and complete details of the tax fraud;
- pay all taxes, duties, interest and penalties due; and
- stop any fraud immediately.

This process is also known as a 'formal disclosure' and it is the only way that a taxpayer can admit to a tax fraud without HMRC launching a criminal investigation. Taking advantage of CDF is also likely to result in lower penalty levels.

The taxpayer has 60 days to decide whether or not to tell HMRC about tax fraud. During that period, HMRC will not contact the taxpayer, although they can still take action against goods that the taxpayer owns, start or continue debt collection or any other action that is needed as part of HMRC's legal obligations. The department advises that taxpayers get independent advice before completing any form or signing a letter.

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Those who choose not to make this commitment will face a full investigation by HMRC, and in some cases a criminal investigation with a view to prosecution. Anyone who signs the contract, but does not go on to admit and disclose fraud, will also face the possibility of a criminal investigation.

Taxpayers who are not under investigation, but who want to admit to tax fraud, may fill out a form to request that HMRC consider their suitability for a CDF arrangement. The department retains the discretion to decide which cases are dealt with civilly, and which are investigated with a view to criminal prosecution.

This is a 'major change from the existing civil investigation of fraud procedure', said Derek Scott, director, tax investigations, KPMG in the UK. He added that the facility 'grants immunity from prosecution to those suspected of fraud if they make an outline disclosure including an admission of fraud within 60 days of being contacted by HMRC. Under the previous Code of Practice 9 procedure, there was only a risk of prosecution in certain circumstances during the course of the investigation regardless of whether or not people co-operated with the authorities. The new CDF addresses the balance by introducing the threat of criminal proceedings in the event of non-co-operation.'

Phil Berwick, director at McGrigors, said the facility 'represents a significant change in the way HMRC conducts investigations where fraud is suspected' and suggested it 'will help facilitate a very substantial increase in criminal prosecutions in the next few years'.

'Taxpayers will be at greater risk of imprisonment and losing the family home. For the more determined tax evaders, the chances of getting off with a fine and a slap on the wrist are diminishing', he added. Under the current rules HMRC have to balance the probability of securing a criminal conviction against a civil settlement, and as it is easier to secure a civil settlement, HMRC were 'often reluctant to take a gamble on criminal proceedings, where the burden of proof is higher'. He noted that 'under the current rules a significant minority of individuals have been stonewalling the Revenue, thwarting the process. HMRC will now have the option of hauling those individuals in front of the criminal courts, the threat of which alone should prompt greater co-operation from taxpayers'.

New trustee is liable

An approved pension scheme had three trustees: a UK company and a married couple who were the only two beneficiaries of the scheme. On 5 November 1996 the couple were replaced as trustees by a Guernsey company. On the same day, the trustees authorised a substantial transfer of funds to another pension scheme, the original UK trustees of which were (also on the same day) replaced by new trustees resident outside the UK. When the Revenue discovered this, they issued a notice under ICTA 1988, s 591B, withdrawing their approval of the scheme with effect from 5 November 1996. The husband applied for judicial review, but the QB dismissed the application. Sullivan J observed that the couple had been removed as trustees 'because they wanted to be removed, and that (the Guernsey company) replaced them as trustees because that is what they wished to happen'. On the evidence, 'this was a chain of actions that was preplanned from the outset.' The transfer of the funds had been made at the couple's request. The husband's witness statement had been 'deliberately misleading' and had not given a 'true and full picture of all the facts'. There had been a deliberate plan 'to export funds out of an approved scheme into another scheme that, whilst it was approved at the moment of transfer, would, immediately the money was transferred, be effectively rendered unapprovable'. The Revenue were clearly justified in withdrawing their approval from the scheme

Following the decision noted above, the Revenue issued an assessment under ICTA 1988, s 591C on the company which acted as the administrator of the scheme. The company appealed, contending that the assessment was invalid and unenforceable.

Decision:

The First-Tier Tribunal rejected this contention and dismissed the appeal. Judge Mosedale observed that 'the purpose of the 40% charge on assets leaving an approved scheme is to re-coup the tax advantages the funds enjoyed while in an approved scheme. If a scheme member does not wish to abide by the rules, and in particular accept the limitations on what can be done with the funds in an approved scheme, then he is not entitled to the tax benefits, and it seems quite reasonable for the Government to seek to recoup them.' She held that the effect of ICTA 1988, s 658A was that 'all administrators from the moment the deemed charge arises onwards are liable, as the charge arises during their control of the funds, although the assessment must be in the name of the administrator at the time of the assessment'. The effect of the legislation was that 'on becoming administrator, the new administrator becomes responsible for the scheme's affairs and liable to discharge its accumulated liabilities. It was not intended by Parliament that changing administrator would relieve the fund of liability to pay an assessment to tax under s 658A.' Accordingly, 'current and future administrators are jointly and severally liable', and tax charged under s 591C 'can be recovered in full from any single relevant person (unless they ceased to be a relevant person before the events in question) on the basis that the assessment of only a single relevant person in the name of the administrator of the scheme establishes joint and several liability of all relevant persons. The liability which is joint and several extends to relevant persons not in existence at the time of the assessment.'

Comments – Generous tax reliefs exist in respect of approved pensions arrangements. Judge Mosedale**'s** observations convey precisely the objective of the legislation. This was an attempt to take advantage of approved arrangements on the way in but not the restrictions on the way out. It was quite rightly doomed to failure.

John Mander Pension Trustees Ltd (TC1528)

Personal Liability Notices (Lecture P698 – 5.52 minutes)

The Social Security Administration Act 1992 was amended in 1998 to introduce a concept of personal liability for directors of companies which failed to pay NIC due. HMRC may issue a “personal liability notice” (PLN) on any director of a company when the company has failed to pay contributions within the time allowed (so not necessarily under circumstances of insolvency) where that failure to pay appears to be due to the fraud or neglect of individuals who were at the time of the failure to pay, officers of the company. In such a case the officer is referred to as a “culpable officer”

(SSAA1992 s121C)

HMRC will issue the notice, taking into account the extent of the officer’s culpability in the company’s failure to pay, and may share the liability between more than one individual. If the company subsequently makes payment, then the liabilities shown on the notices are correspondingly reduced. Interest may be added to the contributions due by the company (which will include both primary and secondary contributions, and Classes 1A and 1B if appropriate) and will be included in the PLN.

Points to note

- The notice is issued following the company’s failure to pay by the due date, and not necessarily its inability to pay. However it is unlikely that HMRC would use this power if they had the option of pursuing the company for the funds.
- Although the legislation provides for an “officer” to be personally liable for unpaid NIC’s, it is unlikely that a company secretary rather than a director would have the degree of control over the company’s affairs to be held responsible for the failure to pay

Appeal case : O'Rorke v Revenue & Customs Commissioners TC01675

This case is an appeal about a subsidiary aspect of the power in section 121C; it concerns whether medical evidence submitted at an earlier hearing should be allowed, and the key issue tested was whether the test of "neglect" in the legislation is an objective test or a subjective one.

Mr O'Rorke was the finance director of L Wear & Co; he resigned as a director on 22 February 2007. On 5 March 2007 the company went into liquidation owing £321,306.60 of unpaid NICs. On 3 September 2009 HMRC issued Mr O'Rorke with a PLN for £290,307.60, and on 25 June 2010 this was reduced to £218,593.77.

Mr O'Rorke appealed against the PLN on the basis that he suffered from an addiction which affected his behaviour, and this ought to be taken into account when assessing whether he was negligent in carrying out his duties.

HMRC argued that the test of negligence in s 121C was an objective test and thus the state of mind or mental capacity of the officer was irrelevant in determining his culpability for the failure of the company to pay. This therefore excluded the submission of medical evidence by Mr O'Rorke to support his claim that he was not culpable due to his state of mind brought about by his addiction. HMRC's view is based on the normal understanding of neglect in other areas of legislation. They claimed that there was no basis on which a different, subjective, interpretation could be based, and that the court was therefore obliged to follow the normal interpretation of neglect – this being an objective test. Had Parliament intended a different meaning to apply, then the law would have made this clear.

HMRC cited a number of cases to support their view, and most particularly *Peter Inzani v R & C Commrs [2006] STC SCD 279*, in which an earlier court definition of neglect set out in *Blyth v Birmingham Waterworks Co (1856) 11 Exch 781*:

> 'Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs would do, or doing something which a prudent and reasonable man would not so.The defendants might be liable for negligence if, unintentionally, they omitted to do that which a reasonable person would have done, or did that which a person taking reasonable precautions would not have done.'

Other cases were cited which also referred to *Blyth*. The *Inzani* case was a similar appeal against a PLN under s 121C, and another case cited was a 2011 appeal against a PLN – *Stephen Roberts & Alan Martin v R & C Commrs [2011] UKFTT 268 (TC).*

The Tribunal considered the matter in some depth and came to the conclusion that as s 121C is a penal provision, the tribunal should be careful in how the legislation is construed. HMRC's view is that as the legislation is clear, the intention of Parliament expressed in Hansard is not relevant (*Pepper v Hart*). However in *J E Chilcott & Others v R & C Commissioners [2009] STC 453* , subsequently upheld by Lord Neuberger with the following :

> 'The fact that some might regard the operation of s 144A, according to its terms as penal, merely emphasises that the court should construe it with care and if there is a narrower construction less beneficial to the Revenue, more beneficial to the taxpayer, available then the court should at least seriously consider it, and if appropriate, adopt it.'

Thus, the Tribunal decided to follow some of the matter quoted in Hansard, and found the test to be a subjective test, which must take into account the state of mind of the officers concerned.

Contributed by Rebecca Benneyworth

More discovery developments **(Lecture P699 – 10.22 minutes)**

For such a fundamental issue of whether or not HMRC can inquire into a tax return outside of the normal window of 1 year from the date of filing, it is worrying that there are seemingly regular disputes having to be heard by the courts. As far as the legislation is concerned it states that discovery assessments can be made in the following circumstances where HMRC can show that there has not been full disclosure:

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

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

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

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

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

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

HMRC v Lansdowne Partners LLP Court of Appeal 20/12/11

A limited partnership carried on business as a fund manager. In August 2005 it submitted its partnership statement for 2004/05, claiming a deduction for certain 'rebated fees', including fees which it had reimbursed to its partners as well as to external investors. In August 2008 HMRC amended the partnership statement on the basis that the fees rebated to partners were not allowable as deductions. The partnership appealed, contending firstly that it was entitled to a deduction for the fees and alternatively that HMRC's amendment was outside the statutory time limit. The General Commissioners accepted both these contentions, and HMRC appealed to the High Court.

In the High Court it was held that the rebated fees did not appear to be 'proper deductions', as they did not appear to be wholly and exclusively for the purpose of the partnership's trade. However, they dismissed HMRC's appeal on the grounds that the commissioners had been entitled to find that the discovery assessment was outside the statutory time limit. The effect of Section 30B(6) TMA 1970 was that the amendment was only valid if, at 31 January 2007, the relevant officer *'could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware that the partnership statement was incorrect*.

On the evidence, the partnership had submitted the relevant information in a letter dated 30 March 2006, so that the commissioners had been entitled to find that HMRC had sufficient information to make a decision whether to raise an additional assessment' before the expiry of the time limit.

In the Court of Appeal the following points arose:

1. The true position is that the hypothetical inspector is not required to resolve the point of law, nor need he forecast and discount what the response of the taxpayer may be. It is enough that the information made available to him justifies the amendment to the tax return he then seeks to make. Any disputes of fact or law can then be resolved by the usual processes.

2. In this case it was held that HMRC received information on the basis of which an officer ought to have been aware that the expenditure in dispute had been excluded or deducted from the taxable profits, with that information being received more than 10 months before the normal enquiry deadline.

3. That was more than sufficient time for HMRC to obtain further information as to the taxpayer's justification for exclusion or deduction and to form a legal view as to the lawfulness of the exclusion or deduction.

4. HMRC's contention that the mere awareness of the fact that an item of expenditure had been deducted is not the same as awareness that the amount of profits stated were insufficient, was rejected.

5. This decision arguably backs up the FTT decision in the case of ***Dr Michael Charlton and Others v HMRC TC1317*** – a decision which has been appealed by HMRC. It provides a degree of balance between HMRC and the taxpayer.

Hankinson v HMRC Court of Appeal 16/12/11

The taxpayer unsuccessfully argued that HMRC were obliged to investigate whether a taxpayer had been guilty of negligence or fraud before issuing a discovery assessment.

The following points arose:

1. The burden of proving the existence of the error and a generally prevailing practice rested on the taxpayer. It therefore made no sense for HMRC to have to investigate the question before issuing the assessment.

2. HMRC did not have an obligation to investigate whether the taxpayer had been guilty of negligence or fraud before issuing the assessment – especially where Section 29 did not impose this obligation.

3. HMRC may regard this decision as giving them new powers, but in reality all it does is show that the discovering officer does not need to be aware of which limb of Section 29 applied when raising the assessment.

Contributed by Gerry Hart

Validity of assessment

The Appellant was a director of Paramount Knitwear (Leicester) Ltd, a company controlled by him and his wife. On 22 December 2003, by way of a Trust Deed, Paramount Knitwear (Leicester) Ltd established The Meridian Funded Unapproved Retirement Benefit Scheme (FURBS). The only members of the FURBS were the Appellant and his wife. In the year ended 31 March 2005 Paramount Knitwear (Leicester) Ltd transferred property with a value of £525,000 to the FURBS. That property comprised a 35 per cent interest in two industrial units and the company's valuations of the units were not in dispute. When HMRC discovered this, it issued an assessment charging tax on the basis that the amounts transferred were employment income of the husband. He appealed, contending that his tax returns had noted that he had received certain benefits from P, so that the assessments had been issued outside the statutory time limits.

Decision:

The First-tier Tribunal rejected this contention and dismissed the appeal, holding that the assessments were authorised by TMA 1970 s 29(5). Judge Tildesley held that the relevant entries in the appellant's returns 'were carefully crafted disclosures seeking to pass through the initial checks carried out by HMRC but in no way meeting the test of clearly alerting an officer of the Board to an actual insufficiency. The entries fell far short of the requirement of a full and complete disclosure to justify an early finality of the assessments.' Accordingly, 'an officer of the Board could not have been reasonably expected on the basis of the appellant's disclosures before the expiry of the enquiry windows to be aware of the actual insufficiency in the tax assessments for 2004/05 and 2005/06'.

Comments - TMA 1970 s 29(5) provides that where an enquiry has not been opened within the statutory time limit, an assessment may only be issued where the officer 'could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the situation'. The Tribunal held that this condition was satisfied here. Judge Tildesley's comments are self-explanatory.

A Omar v HMRC (TC01559)

Underdeclared takings – onus of proof?

A trader (C) carried on a business of repairing motor vehicles. HMRC began an enquiry into his return for 2006/07, which declared turnover of £42,777. They subsequently issued a closure notice amending his return to charge additional tax of £17,663 (on the basis that his turnover for the year had been more than £94,000), and also issued estimated assessments for 2004/05, 2005/06 and 2007/08, computed by applying the RPI to the estimated turnover for 2006/07. C appealed, contending that much of his income in 2006/07 had derived from gambling winnings.

Decision:

The First-tier Tribunal reviewed the evidence in detail and substantially allowed his appeal. Judge Reid found that HMRC's estimate of C's turnover for 2006/07 was 'wholly unrealistic', since it suggested that 'there would have to have been a constant stream of motor vehicles passing through the appellant's premises fifty weeks a year and a production rate of six or seven vehicles every day'. He directed that the 2006/07 liability should be recomputed on the basis that C's turnover for the year had been £60,000. He also held that the estimated assessments for other years should be discharged, holding that the application of the RPI was not 'a legitimate way of proceeding' and observing that C's declared turnover for 2007/08 was £61,234, which was in line with the turnover as found by the tribunal for 2006/07. He commented that it was impossible to 'form any view as to the extent to which, if at all, the appellant has underdeclared his turnover in these earlier years. This seems to distinguish the collection of cases on this general topic conveniently gathered together in Simon's Taxes (online version) at section A5.136.'

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Comments - The discussion in Simon's Taxes, referred to in Judge Reid's decision, indicates that in general the onus of proof is on an appellant to disprove an assessment. However this does not give HMRC 'carte blanche' to issue unreasonably high assessments, as happened here. The case is reminiscent of the well-known case of Scott & Scott (t/a Farthings Steak House) v McDonald [1996] SSCD 381.

This also demonstrates in most cases there is a specific methodology behind the figures arrived at by HMRC. However such methodologies need to be examined carefully as they may not always withstand detailed scrutiny as was amply demonstrated in this case.

W Chapman v HMRC (TC01593)

HMRC Task Forces **(Lecture P700 – 8.58 minutes)**

Taskforces bring together various HMRC compliance and enforcement teams for intensive bursts of activity targeted at specific sectors and locations where there is evidence of high risk of tax evasion. They are a direct result of the Government's £917m spending review reinvestment to tackle tax evasion, avoidance and fraud, which aims to raise an additional £7bn each year by 2014/15.

Compliance activity through taskforces targets the highest-risk cases in specific sectors and location, typically focusing on groups of up to around 600 customers.

Taskforces aimed at the restaurant sector were launched in May/June 2011 in London, the North West of England and Scotland, so far involving 531 restaurants being investigated (including 222 in Scotland alone). A taskforce aimed at London fast food outlets was launched in July 2011.

Five new taskforces were announced on 7 November 2011 and if you have clients within any of the categories you may wish to warn them of the possibility of HMRC approaching them. Indeed it is an opportunity for you to check the business records and identify any problem areas in the event of HMRC scrutiny. The five new taskforces are:

1. scrap metal dealers in Scotland, focusing on those deliberately suppressing income or inflating expenditure to evade tax
2. construction traders who are self-employed or run their own company who suppress sales or over-claim expenses in the North West and North Wales
3. taxpayers not submitting their statutory returns across Corporation Tax, Income tax Self Assessment, PAYE and VAT in the South East
4. fast food outlets in Scotland deliberately falsifying their records and misdeclaring their true sales levels to avoid paying the correct taxes
5. landlords – owning or renting three or more properties – evading their tax responsibilities in North West and North Wales.

HMRC is planning 12 taskforces in 2011/12 so that means a further 5 to be announced soon. More are planned to follow in 2012/13.

Overseas holiday homes

As a separate initiative *HMRC is targeting UK residents with overseas properties.* A 200-strong team of investigators and specialists in the "affluent unit" will use software to trawl publicly available information to identify individuals who own property abroad and could owe income tax from rental income or CGT from property sales.

HMRC will use "risk assessment" tools to highlight people who do not appear able legitimately to afford the property, as well as those who do not appear to be declaring the correct income and gains from the property.

HMRC investigators will also ask holiday home owners how they funded the property and whether it has been declared as an income source. The unit is targeting people with assets between £2.5m and £20m and people who should be paying the 50% rate of income tax.

HMRC reckons that the new unit could claw back £560m in taxes by 2014/15. A spokesperson for the government department said that its property unit would follow the 'model' of HMRC's **High Net Worth Unit**, which was created in 2009 to deal with the personal tax affairs of the UK's wealthiest individuals and brought in £85m in tax receipts for 2009/10 and £162m for 2010/11.

Contributed by Gerry Hart

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BUSINESS TAX

Defending its reputation: wholly and exclusively? (Lecture B698 –6.56 minutes)

S was the sole shareholder and director of the appellant company consultancy business. In 2004 the appellant became involved with another company ("A") and two of the appellant's institutional clients became shareholders of A. P was the CEO and M was the chairman of that company. In 2007 and 2008 P wrote to S indicating that M should be removed as chairman. On 8 February 2008 S sent an email to various addresses, including the institutional clients, setting out those views and proposing M's removal from the board. On 3 March 2008 P wrote to various recipients, including the institutional clients, stating that he was aware of emails seeking support for an extraordinary general meeting ("EGM") to pass a resolution removing M and of assertions that there was a rift between the executive team of A and M, who lacked the support of the executive directors. The letter went on to state that 'the assertions were wholly untrue'. The appellant and S believed that that letter implied that S was deliberately saying things that were untrue, in order to achieve his own agenda of removing M from A's board. S and the appellant therefore sued A and P for libel, incurring legal costs of £459,924 before the proceedings were settled after the first week of trial, and which were paid by the appellant. In its company tax return for the period ended 30 June 2008, the appellant sought to deduct those costs under TA 1988 s 74(1)(a).

HMRC disallowed the 75 per cent of the expenditure on the grounds that there was a duality of purpose, ie a business purpose of the appellant as well as a private purpose for S. That deduction was increased to 50 per cent on the appellant's review. The appellant appealed on the basis that the entire costs should be allowed.

Decision:

The tribunal found that on the particular facts of the specific case, the sole purpose of bringing the defamation proceedings was to protect the business reputation of the appellant. Adding S as a second claimant served the purpose of increasing the likelihood of the defamation claim succeeding. However, that would not affect the purpose itself, which was to protect the business reputation of the appellant. Furthermore, any personal benefit to S was an effect of, rather than a reason for, the expenditure on the defamation action. It followed that the appeal would be allowed.

Appeal allowed.

Comments – One of the fundamental principles involved in the computation of a business's trading profit is that of the expense being incurred wholly and exclusively for the purpose of the business. Clearly where there is or may be a duality of purpose this may result in either the whole expense being disallowed or where there is an identifiable business proportion being apportioned appropriately. The strength of the facts and argument in this case caused the Court to view the relationship between the personal benefit and the business reason to be effectively that the business reason was overwhelmingly the most important hence the successful outcome.

Key IP Ltd v Revenue and Customs Comrs TC 1552

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Defending criminal prosecution: wholly and exclusively? (Lecture B698 – 6.56 minutes)

A married couple traded in partnership as haulage contractors. The husband was convicted of polluting a tributary of a river with insecticide (causing the death of more than 100,000 fish). The partners claimed the costs of defending the criminal proceedings as a deduction. HMRC issued amendments to the partnership statements, disallowing the deductions, and the partners appealed.

Decision:

The First-tier Tribunal dismissed the appeals. Judge Long observed that the prosecution had been against the husband as an individual, rather than against the partnership. On the evidence, 'there was a personal motivation in incurring the expenditure as well as a business one'.

Comments - The Tribunal upheld HMRC's view that the costs of defending criminal proceedings were not wholly and exclusively for the purpose of the defendant's business. It is unusual to get two cases reported in such close proximity dealing with the same basic point - the duality of purpose when dealing with costs incurred in defending a criminal prosecution or a legal action. This is another case demonstrating the real importance of the wholly and exclusively principle.

MA & Mrs BC Raynor v HMRC (TC01649)

Capital allowances update (Lecture B696 – 14.43 minutes)

Fixtures in buildings

The Government has published amended proposals for changes to the tax treatment of fixtures in buildings. The key features are:

1. The original proposal that expenditure on qualifying fixtures should be pooled within 1 to 2 years of purchase is not being implemented. Instead, such expenditure must be pooled before a subsequent transfer on to another person, if the new owner is to be able to claim capital allowances.

2. Joint elections under s.198 CAA 2001 may still allocate any value to the fixtures, as long as that value does not exceed the vendor’s original cost. The original proposal of setting a minimum transfer price equal to the vendor’s TWDV is not being proceeded with, so the election will still be a way of allocating allowances between the parties in the most favourable way (e.g. by setting a price of £1 on fixtures, where the purchaser (such as a developer or charity) is not able to claim capital allowances).

3. Where a s.198 election is not made, presumably as agreement cannot be reached, the matter will have to be referred (under s.563 CAA), within 2 years, to a First-Tier Tribunal for an independent determination.

The expectation is that a s.198 election will be the norm, so as to avoid the cost and uncertainty of referral to the FTT.

HMRC makes it clear in the consultation document that ‘pooling’ does not mean that a person must claim allowances. It will still be possible to make partial claims, or disclaim allowances, where this optimises the tax position (e.g. in years when business profits are low and allowances would be wasted).

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Another change from the original proposals is that there is now no intention of amending the fixtures anti-avoidance rule (s.197), which prevent the artificial acceleration of capital allowances.

Anti-avoidance Rules for Plant and Machinery

The following changes will be made to the anti-avoidance rules that apply to transactions involving plant or machinery.

1. There will be a new purpose test which will refer to a 'transaction to obtain tax advantages' rather than to a 'transaction to obtain allowances'. A 'transaction to obtain tax advantages' will be defined as one
   - with an avoidance purpose; or
   - that is part of, or occurs as a result of, a scheme or arrangement that has an avoidance purpose.

2. The meaning of the word 'assigns' will be clarified in legislation so that it covers novations.

3. The exception from the anti-avoidance rules, where the plant or machinery is acquired from a manufacturer or supplier, is being repealed in relation to expenditure incurred on or after 12 August 2011.

Feed-in Tariffs and the Renewable Heat Incentive

The following changes are planned to the capital allowances treatment of expenditure on plant or machinery used to generate renewable electricity or heat.

1. From April 2012, expenditure on solar panels will be special rate expenditure.

2. From April 2012 (or April 2014 for combined heat and power (CHP) installations) enhanced capital allowances (ECAs) will not be available in respect of expenditure on plant or machinery when it generates electricity or heat that attracts tariff payments under either the Feed-in Tariffs or Renewable Heat Incentive schemes. ECAs may still be claimed in respect of expenditure on such equipment as long as no tariffs are paid.

Business Premises Renovation Allowances

The BPRA scheme, which provides 100% allowances for renovation expenditure on the structure and fixtures of empty business property in disadvantaged areas, will be extended by secondary legislation for five years until 11 April 2017.

Capital allowances in Enterprise Zones

Where trading companies incur expenditure on qualifying plant or machinery for use primarily in *designated areas* (see below) within Enterprise Zones, it will qualify for100% FYA. The key details are:

1. The qualifying expenditure must be incurred between 1 April 2012 and 31 March 2017.

2. The area in which the plant or machinery is to be used must be an assisted area at the time when the expenditure is incurred.

3. The plant or machinery must not be held for use in an area outside of the designated assisted area for a period of five years.

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4. Assets held for leasing will be excluded (as is usually the case with FYAs).

5. The expenditure must be on plant or machinery that is new and unused (not second-hand) and must be investment rather than replacement expenditure.

6. The company incurring the qualifying expenditure must not be a firm:
   - in difficulty for the purposes of the Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C 244/02); or
   - engaged in the fisheries and aquaculture sectors, nor in the management of waste of undertakings; or
   - engaged in any of the coal, steel, shipbuilding or synthetic fibres sectors; or
   - engaged in the primary production of agricultural products.

An area may be 'designated' by Treasury Order if at the time the order is made:

- the area falls wholly within an enterprise zone; and
- a memorandum of understanding in respect of the area, relating to the availability of allowances, has been entered into by the Treasury and the responsible authority for the area.

Note that over 20 Enterprise Zones have now been announced.

Kevin Read (January 2012)

Planning for the reduction in the AIA **(Lecture B697 – 12.12 minutes)**

The 100% AIA is reducing from £100,000 per annum to only £25,000 from 1 April 2012, as announced some 18 months ago so that businesses could plan in plenty of time.

There are in fact some planning opportunities which can be considered even as we get ever closer to the start date.

Calculating the AIA

The amount claimable is subject to time-apportionment where the accounting period straddles 31 March (5 April for sole traders and partnerships).The maximum AIA is tabulated below, from which it can be seen that the AIA reduces by £6,250 per month between April 2012 and March 2013:

Year end	AIA
30/4/12	£93,750
31/5/12	£87,500
30/6/12	£81,250
31/7/12	£75,000
31/8/12	£68,750
30/9/12	£62,500
31/10/12	£56,250
30/11/12	£50,000
31/12/12	£43,750
31/1/13	£37,500
28/2/13	£31,250
31/3/13	£25,000

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The relevant AIA limit has to be looked at not just by reference to the apportioned amount over the whole year end as above, but also to the amount applying for the portion of a year falling on or after the date of the rate change. Section 51A (6) and (7) CAA2001 covers a chargeable period beginning before 1 April 2012/ 6 April 2012 and ending on a later date. The maximum AIA for that period is the sum of the maximum AIA found if (a) the period from start to 31 March 2012 (5 April) and (b) the period from 1 April 2012 (6 April) to the end of the chargeable period were separate chargeable periods. However, for expenditure from 1 April (6 April) 2012 to the end of the actual chargeable period the maximum AIA is (b) above.

Illustrations

Maximum AIA for the year to 31/12/12 is £43,750. If no expenditure incurred in the period 1/1/12 to 31/3/12, the maximum allowed for that year is by reference to expenditure in the period 1/4/12 to 31/12/12 of £18,750 (9/12 x £25,000).

For the year to 30/4/12 the maximum AIA is £93,750, of which only £2,083 is claimable in April 2012 (1/12 x £25,000). That is a trap, as often a business will seek to delay expenditure until the last month of its accounting period so as to minimise the period between incurring the expenditure and getting the tax relief.

Using the rule which determines when expenditure is incurred

Taking the year end as 30 June 2012, the AIA is £81,250 of which £6,250 is claimable on expenditure in the period 1 April to 30 June 2012. If that is a problem and the business is unable to accelerate an equipment purchase to March, there is still scope as the basic rule in Section 5 CAA2001 is that expenditure is incurred on the date on which the obligation to pay becomes unconditional. Ordinarily a business must pay for goods on delivery, unless special payment terms exist.

That basic rule therefore means that for the purposes of capital allowances the obligation to pay is unconditional when the goods are delivered, and the delivery date is the date the expenditure is incurred even if no payment is made then because special terms exist whereby, for example, payment does not have to be made for a while.

There is however a maximum gap of 4 months allowed between delivery and payment for this purpose – per Section 5(5) CAA2001.

Illustration

Planned expenditure of £60,000 for equipment to be bought in June 2012. To avoid the restriction in the AIA it is decided to advance the contract to buy to 31 March 2012 with delivery in that month. The supplier agrees that payment can be made as under:

31 March 2012	£3,000
1 June 2012	£6,000
1 July 2012	£51,000

As all the payments are not required to be made more than 4 months from the date on which the obligation to pay becomes unconditional (31 March 2012), the whole of the £60,000 is treated as incurred on 31 March 2012 and full AIA is available.

That would not be the case if, for example, the £50,000 final payment was not required to be made until, say, 1 *September 2012.*

Under an HP contract it can be easier to bring forward the date on which expenditure is incurred. This is because under Section 67 CAA2001 expenditure still to be incurred at the time the asset is brought into use is treated as incurred when the asset is brought into use. HP agreements nowadays often use other terminology (e.g. lease purchase), and the important point to determine for HP treatment is that the purchaser is not legally the owner of the asset until the final payment has been made and when that has been paid he duly becomes the owner.

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100% tax relief via an SSAS

Under a Small Self-Administered Pension Scheme (SSAS) a loan can be made to the company to enable it to buy equipment, subject to the following conditions:

- the loan must be secured as a 1st charge on the equipment
- the loan cannot exceed 50% of the SSAS fund value
- interest must be charged at above the base rate
- the loan period must not exceed 5 years

Illustration

A limited company wishes to purchase equipment costing £40,000 at a time when their AIA is only £25,000.

A pension contribution is made of £30,000 (or funds are already in the SSAS of at least that amount), and a loan-back of £15,000 is made to the company which it uses to buy the equipment together with £25,000 of its own funds.

The company obtains corporation tax relief on the following:

- £25,000 AIA
- £15,000 WDA over a period with 18% claimable per annum on the reducing balance
- £30,000 pension contribution

Contributed by Gerry Hart

Basics of Statutory Demergers **(Lecture B699 – 15.11 minutes)**

A demerger is a way of separating the trading activities of the company or the separation of companies in a group. This may result in the separate entities being owned by the same shareholders (a reconstruction), or in the separate entities being owned by different groups of shareholders (a partition).

A statutory demerger is a reconstruction or partition which is carried out in defined steps and which meets certain conditions, as a result of which there is an exemption from income tax on distributions for the shareholders, and the distribution will be treated as a reorganisation of share capital for CGT purposes. Also, where an asset has been transferred between group companies under s 171 TCGA 1992, a s 179 charge will not arise if the company holding the asset leaves the group as a result of an exempt distribution within six years of the original intra-group transfer. There are similar rules covering the intra-group transfer of intangible assets under s 787 CTA 2009.

There are no special reliefs for the transferor company itself on the disposal of a trade or shares in a subsidiary, although in the latter case substantial shareholding exemption (SSE) may be available. Also, there are no special reliefs for stamp duty or SDLT, although it may be possible to make use of existing reconstruction reliefs.

There are three types of demerger set out in the legislation in ss 1076 and 1077 CTA 2010.

Type 1 demerger

The transfer by a company to all or any of its shareholders of shares in one or more companies which are its 75% subsidiaries.

For example, a holding company, A Limited, with two subsidiaries, B Limited and C Limited has two shareholders, X and Y. A Limited could transfer, say, C Limited to X and Y, or to, say X only. Relief under the exempt distribution demerger provisions could be obtained in either scenario, although other tax implications will differ. For example, stamp duty exemption may be available in the first scenario, but not in the second.

Type 2 demerger

The transfer by a company to one or more other companies of a trade or trades, and the issue of shares by the transferee company or companies to all or any of its shareholders.

For example, A Limited is owned by X and Y, and carries on two trades, Trade 1 and Trade 2. X and/or Y could form a new company, B Limited into which one of the trades, Trade 2, is transferred. As consideration for the transfer of the trade B Limited will issue further shares to X and/or Y.

Type 3 demerger

The transfer by a company to one or more other companies of shares in one or more 75% subsidiaries, and the issue of shares in the transferee company or companies to all or any of the shareholders of the transferor company.

For example, A Limited, which is owned by X and Y, has two subsidiaries, B Limited and C Limited. X and/or Y will form Newco into which the shares in C Limited will be transferred. As consideration for the transfer, Newco will issue further shares to X and/or Y.

General Conditions

There are a number of conditions that must be met in order to secure the relief.

A. The companies involved in the demerger must be resident in an EU member state.

B. The distributing company must be a trading company or the holding company of a trading group, and each subsidiary being transferred must be a trading company or the holding company of a trading group.

C. The distribution must be made wholly or mainly for the purpose of benefiting some or all of the trading activities which were carried on before the distribution, and which after the distribution will be carried on by two or more companies or groups.

D. The distribution must not form part of a scheme or arrangement, the main purpose or one of the main purposes of which is the avoidance of tax; the making of a chargeable payment (see below); or the acquisition by any persons other than members of the distributing company of control of the distributing company, any relevant company, or any company which belongs to the same group as the distributing company.

Additional Type 1 demerger conditions

E. The transferred shares must be irredeemable, and constitute all or nearly all of the distributing company's shareholding in the company transferred, together with the voting rights.

F. After the distribution the distributing company must be either a trading company or the holding company of a trading group.

Additional Type 2 and 3 demerger conditions

G. If a trade is transferred, the distributing company must either not retain any interest in that trade or retain only a minor interest in it.

H. If shares in a subsidiary are transferred, those shares must constitute the whole or substantially the whole of the distributing company's holding of the ordinary share capital of the subsidiary, and of the voting rights.

I. The only or main activity of the transferee company after the distribution must be the carrying on of the trade, or the holding of the shares transferred to it.

J. The shares issued by the transferee company must be irredeemable, and must constitute the whole or substantially the whole of its ordinary share capital and of the voting rights.

K. After the distribution the distributing company must be either a trading company or the holding company of a trading group.

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Additional conditions where the distributing company is a subsidiary

L. The group (or largest group) to which the distributing company belongs must be a trading group.

M. The distribution is followed by further qualifying distributions resulting in members of the holding company of the distributing group becoming members of the transferee group.

Chargeable payment

Broadly, these are payments of any kind by a company to its members, directly or indirectly, which are money payments or the transfer of money's worth.

However, chargeable payments do not include:

- •distributions, or
- •exempt distributions, or
- •payments made for genuine commercial reasons.

Clearances and returns

Clearance is obtained from HMRC in advance of the transaction to ensure that they are satisfied that the exempt distribution provisions apply.

A return of any exempt distributions made by a company must be made within 30 days of the distribution.

Contributed by Paul Howard

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VAT

Littlewoods: compound interest claims

Littlewoods Retail Ltd and others v HMRC (Case C-591/10) is the current lead case in relation to compound interest in the context of VAT. Given the high values at stake and the multiple cases proceeding on variants of the point, it was hoped the opinion of Advocate General Trstenjak would bring some welcome clarity to the complex legal issues involved.

Vos J in his preliminary judgment of May 2010 ([2010] EWHC 1071 (Ch)), rejected a right to compound interest under UK law as he determined that VATA 1994 ss 78 and 80 provided an exhaustive and exclusive statutory regime, but he referred four questions to the Court of Justice of the European Union (CJEU) regarding the application of European law principles:

- Question 1: Does the payment of simple interest as a remedy accord with EU law?
- Question 2: If not, does EU law require that the remedy should provide for payment of compound interest as the measure of the use value of the sums overpaid in the hands of the Member State and/or the loss of the use value of the money in the hands of the taxpayer?
- Question 3: If the answer to 1 and 2 is no, what must the remedy include?
- Question 4: If the answer to question 1 is no, does the EU law principle of effectiveness require a Member State to disapply national law restrictions (such as VATA 1994 ss 78 and 80) on any domestic claims to give effect to the EU law right established in answer to the first three questions, or can the principle of effectiveness be satisfied if the national court disapplies such restrictions only in respect of one of these domestic claims or remedies?

Principle of effectiveness

There are two aspects of Trstenjak's opinion that represent welcome clarification of EU law. First, Trstenjak candidly admits that it can be misleading to speak of the 'procedural autonomy' enjoyed by Member States in relation to claims for the reimbursement of tax collected contrary to EU law. As she points out, Member States have a duty to procedurally facilitate the enforcement of claims stemming from EU law in order to ensure its full effect. This, she rightly observed, is closely connected with the principle of effective judicial protection and the fundamental right to an effective remedy. National procedural autonomy is also constrained by the requirement to ensure that the national remedy is effective and equivalent.

Second, Trstenjak recognises that in cases of overpaid tax, EU law accords the taxpayer a right not only to reimbursement of the principal amount, but also to interest on that amount. In reaching this conclusion, Trstenjak openly favoured a line of cases beginning with Metallgesellschaft Ltd v ICR and Others (Joined Cases C-397/98 and 410/98) [2001] ECR I-1727 over an earlier line beginning with Roquette Frères v Commission (Case 26/74) [1976] ECR 677, which have sometimes been read as treating interest as entirely a matter for the national law.

The Advocate General further reasoned that the right to interest recognised in Metallgesellschaft applies not only where the tax is charged prematurely (as it had been in that case), but also where the tax should not have been charged at all. This is plainly logical and hopefully finally disposes of the contrary view, on which Vos J had rested his conclusions in the main action.

Trstenjak distils the principle from Metallgesellschaft and FII (Case C-446/04) as follows. She says that 'because of the unavailability of sums of money as a result of tax being levied (in breach of EU law), the taxpayer has suffered losses which are to be regarded as amounts retained by the Member State or paid to it in breach of EU law'. She concludes 'Member States … must in principle … pay interest in compensation for the unavailability of the sums paid'.

Trstenjak considered the UK had fulfilled its duty to provide an interest claim through VATA 1994 s 78, which would comply with the principle of effectiveness provided that the resulting interest award is not 'so low that it largely deprived the interest claim stemming from EU law of substance'.

This conclusion is entirely new and a creature of Trstenjak's own creation. It is also starkly at odds with the CJEU's prior jurisprudence. Contrast the principle stated by the CJEU at para 205 of FII

'where a Member State has levied charges in breach of … Community law, individuals are entitled to reimbursement not only of the tax unduly levied but also of the amounts paid to that State or retained by it which relate directly to that tax'; 'that also includes losses constituted by the unavailability of sums of money'. The only way to rationalise this with Trstenjak's proposition would be if a payment of interest which did not fully compensate the loss suffered by the taxpayer or reimburse the benefit retained by the Member State is to be taken as being so low as to deprive the interest claim of substance.

Here, Littlewoods had received some £268m in simple interest under s 78. This payment, Trstenjak says, 'readily complies with the principle of effectiveness' seemingly on the basis that it exceeded the principal tax sum by more than 25%. The amount of interest Littlewoods received was, perhaps, large in absolute terms but that does not of itself lead to the conclusion that the payment is either adequate compensation for the loss suffered by the taxpayer or reimbursement of the amount retained by the Member State as the CJEU required in FII.

This aspect of the opinion is open to a number of criticisms. First, it is the role of the CJEU to provide guidance on the interpretation of EU law and the principles that domestic courts must adhere to. The question of whether the actual amount of interest received by Littlewoods complies with the principle of effectiveness is a matter for the domestic court and is not within the CJEU's competence. This is rightly so as the approach taken by Trstenjak belies confused economics.

The amount of interest received was large because the tax amount itself was large and it had remained outstanding for a long period of time. It is incorrect to look at the amount of interest as a percentage of the total tax repaid; interest compensates for the fact that the real value of an amount of money declines with the effluxion of time. What is required, as per the CJEU in FII, is to ask what was the loss suffered by the taxpayer or the benefit retained by the Member State? In proportionate terms, the simple interest payment represented only 20% of the total amount of the interest benefit Littlewoods said that the UK had enjoyed, calculated on a compound basis. Or put another way, the Member State has retained 80% of the benefit of tax levied in breach of Community law, which we have been told by the CJEU it is obliged to reimburse. It is difficult to see how this does not largely deprive the right to interest of substance. The influence of current political and economic considerations is clear.

Principle of equivalence

The most significant aspect of the opinion is understanding the AG's conclusion that '… rules governing the claim for payment of interest on VAT collected in breach of EU law may be no less favourable than the detailed rules governing similar interest claims stemming from a breach of domestic law' (para 39).

The AG identifies potential categories of similar domestic interest claims to be used for comparison, for example, whether interest on VAT collected in breach of EU law should be compared with interest on unlawfully levied direct taxes. Unfortunately, she does not provide her own views on what the comparators

should be but says that this should be the subject of a further detailed reference to the Court. Should the CJEU reiterate that position, a further reference seems inevitable. It is worth noting that when considering the principles set down, inter alia, in San Giorgio and FII the CJEU saw no need to delineate between indirect or direct taxes levied in breach of Community law. What mattered was the breach of Community law, not the nature of the tax. This point is now of utmost importance as if claims for interest on direct taxes are the correct comparator then the principle of equivalence will be breached (compound interest having been available in Sempra Metals [2007] UKHL 34).

Finally, where multiple causes of action are available to a claimant, such as a Woolwich claim or a mistake of law based claim, the AG confirms that it is for a taxable person to choose which to pursue, rather than for the courts to restrict the taxable person to a particular avenue and thus a particular remedy.

Where does this leave us?

There is a long way yet to go for Littlewoods in this case. In particular it remains to be seen how the CJEU will deal with the difficulties in rationalising Trstenjak's opinion with its earlier case law.

Too late to join flat rate scheme

In 2009, the taxpayer registered to use the VAT flat rate scheme. The taxpayer's adviser then wrote to HMRC asking to have the company's registration backdated to 2005, as this would result in a VAT repayment of approximately £17,735.

HMRC refused to allow retrospective registration, saying that this would only be possible where an alternative calculation of the VAT due had not already been submitted or in exceptional circumstances, for example if the company had been misdirected by an HMRC officer or if the business was under threat. Neither of these situations applied to the taxpayer, and the fact that the company had a corporation tax bill to pay did not constitute hardship.

Decision:

The First-tier Tribunal said that HMRC were applying a rational policy 'designed to provide a consistent approach to the exercise of a discretion'. The taxpayer's appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, said 'advisers need to identify potential VAT savings with the flat rate scheme as soon as possible, there is little or no scope to go back in time if the opportunity is missed. The legislation states that a taxpayer can join the scheme at the beginning of the next VAT period after his application has been received, and HMRC allow a concession back to the beginning of the current VAT period, as long as the return has not been submitted'.

Anycom Ltd (TC1496)

Apportion the supply

The taxpayers, a husband and wife, converted their main residence into two semi-detached properties. The couple lived in one of the properties, but sold the other. The floor space of the property that was sold consisted of 35% of the original property, with the remainder being newly constructed.

HMRC denied the taxpayers' application to be registered for VAT as intending traders so that the building work could be zero rated. The department refused this on the basis that the taxpayers had converted an existing building which, according to VATA 1994, Sch 8 group 5 note 16 meant that zero rating could not apply. The taxpayers appealed.

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Decision:

The First-tier Tribunal said that the work carried out by the taxpayers amounted to an enlargement, as opposed to a conversion or alteration, of the existing building. The tribunal judge said it was clear that an additional building had been created; it would not have been possible to do this without enlarging the existing property. However, it was also the case that the new property incorporated part of the original house. He decided that it would be appropriate to apportion the supply, so that the new part was zero rated, and the part incorporated in the existing building was exempt. The tribunal judge therefore found that the taxpayers did intend to make a taxable, zero-rated supply and should be registered for VAT.

The taxpayer's appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said the case highlighted: 'how property deals can produce some very challenging situations where the VAT issues are not clear-cut. The tribunal looked at the bigger picture by reviewing what existed on the site before and after the works had been carried out. It was decided that a new dwelling had, in reality, been created, i.e. with some scope for input tax recovery because of a zero-rated sale being made in part.'

A and M Wright (TC1523)

VAT bad debt relief: technical note **(Lecture B700 – 21.00 minutes)**

This article reviews some recent case law developments on bad debt relief (s.36 VATA 1994 and SI 1995/2518 reg.165ff.). The basic conditions for claiming the relief are as follows:

A trader can claim a refund of output VAT on a bad debt if:

(a) he has supplied goods or services for consideration and has accounted for and paid the tax thereon (so not if the trader is using the cash accounting scheme, because the tax will not have been accounted for);

(b) the whole or part of the consideration has been written off in the trader's accounts as a bad debt, and

(c) six months have elapsed (measured from the later of the tax point and when the payment was due).

For this purpose, a trader can 'write off the debt' in a memorandum account that is outside the double entry bookkeeping system. It is sufficient to keep a record to show which specific debts have been the subject of a claim, so HMRC can check that the other conditions are all satisfied.

Where the entire debt is written off as unpaid, all the tax on that debt can be claimed from HMRC. Where there have been payments received for part of the debt only the tax on the remaining unpaid part can be refunded. There are specific rules about identifying receipts with invoices, which makes a difference if different rates of VAT apply to different parts of a debt.

Claims are made by including the allowable VAT on a bad debt in Box 4 (input tax) on a VAT return, not by reducing output tax.

If the customer subsequently pays part or all of the debt, the trader is supposed to reverse the previous claim by entering the output tax in Box 1 of the return for the period in which the money is received.

A customer that has claimed input tax on a supply but has not paid the supplier of the goods or services within six months of date of supply (or the date on which the payment is due if later) is required to repay the input tax. This is intended to be related to the supplier's bad debt claim, but there is no requirement for the debtor and creditor to communicate about this. The debtor is simply supposed to notice that an invoice, on which input tax has been claimed, remains unsettled. The input tax is repaid by reducing the input tax on the VAT return for the accounting period in which the end of the six months falls.

A claim for BDR cannot be made more than 4 years and 6 months after the later of the date of supply and the due date for payment. There is therefore a four year "window" in which the claim can be made.

Credit note or bad debt?

A car dealership company (B) sold Ford cars. B had no corporate relationship with Ford. In 2002 B went into receivership. It held a number of cars for which it had not paid F. In accordance with the supply agreement between the two companies (which was terminated if either party went into an insolvency procedure), F reclaimed the cars and issued credit notes. The supply agreement contained a "retention of title" clause which was legally effective and which entitled F to recover its cars in priority to other creditors.

B's receivers needed to continue the business in order to try to sell it as a going concern, for which they needed stock. They agreed with F that, after the credit notes had been issued, F would re-sell the same cars to the receivers on the same terms. In effect, F exercised its rights under the supply agreement by issuing the credit notes, but then decided to carry on a new informal supply agreement with the receivers. The cars were not physically repossessed by F.

B's receivers subsequently submitted a claim for repayment of input tax in respect of these cars. The Commissioners rejected the claim and B appealed, contending that the credit notes should not have been treated as effective for VAT purposes (cancelling the input tax entitlement in the pre-insolvency period), and that F should have claimed bad debt relief instead. This would have benefited B because B would not have had to repay the input tax under the usual bad debt rules if an insolvency procedure commenced between the input tax claim and the six month deadline at which F would make its claim.

This was particularly important to the administrative receiver from Baker Tilly, who was being sued by a secured creditor for accepting the credit notes at face value. The creditor, NatWest, argued that the proper treatment would have resulted in a much higher recovery for itself. The administrator therefore claimed back the VAT essentially in order to pay NatWest, using the argument put forward by NatWest in its lawsuit.

The Tribunal rejected this contention and dismissed B's appeal, holding that the credit notes had been correctly issued and that F could not have claimed bad debt relief since it had legally (if not physically) "recovered" the cars in accordance with the supply agreement. The original supply had been reversed, so there was no input tax for B to claim. However, it was not a straightforward case: the company's counsel had argued strongly from precedent cases that the supply did not cease to be a supply because of the retention of title clause, and the reclamation of the cars by F was not a supply either.

The High Court confirmed the Tribunal's decision. The parties had agreed that the first supply agreement had been rescinded, cancelling the original supplies, and the credit notes were validly issued on that basis.

In early 2009, the Court of Appeal remitted the case to the Tribunal for reconsideration. The credit notes would only have the effect of cancelling the original supply (and therefore cancelling the associated right to input tax) if there was a contractual agreement between B and F that the supply should be cancelled. The original Tribunal did not consider this question: it appeared to accept that the credit notes must be assumed to reflect such a contract, rather than questioning whether the credit notes did so.

As the Tribunal's primary findings of fact did not justify its conclusions, it should examine the case again. It was possible that it would come to the same answer, but it was also possible that it would accept the taxpayer's argument: F acted unilaterally in repossessing the cars and issuing the credit notes, and B accepted that conduct not because of a contractual agreement but because it had neither the power nor the commercial incentive to do anything else.

The case was further complicated by the death of the original Tribunal chairman to whom it was remitted; Judge Nowlan then could not agree with his Tribunal member, Julian Stafford, and had to reach a decision based on his own casting vote. The decision therefore repeats the facts and the possible legal analyses in considerable detail and reaches the conclusion that there was no agreement to rescind the contract. This means that the dealer has won (unless HMRC appeal again) – if there was no rescission, the credit notes were ineffective, and bad debt relief should have been claimed instead.

First Tier Tribunal (TC01432): *Brunel Motor Co Ltd v HMRC (and related appeal)*

<u>*Reduction in consideration or bad debt?*</u>

Cumbria County Council supplied services to DEFRA during the 2001 foot and mouth outbreak. DEFRA refused to pay in full, and the amount was finally settled by mediation. As the Council had accounted for output tax on the full amount, it made a voluntary disclosure to claim some of it back (over £220,000). This was refused on the basis that it was a bad debt claim made outside the statutory time limits.

The Council asked for a review (and then another), arguing that it was not claiming bad debt relief but an adjustment of consideration under reg.38 SI 1995/2518. There should be no time limit on reg.38 claims.

The Tribunal examined the history of the transactions, invoices and subsequent dispute. It was clear that the Council had been required to act for DEFRA without agreeing terms in advance, and found itself in disagreement about how much would be reimbursed after the event.

The Tribunal found that the settlement constituted an adjustment of consideration within reg.38 SI 1995/2518 rather than a bad debt claim. Accordingly, the time limit for such claims did not apply, and the appeal was allowed.

The HMRC officer who took the decision was criticised by the Tribunal judge for making an assertion that the settlement between the Council and DEFRA was "factitious" (by which the Tribunal understood him to mean in some way artificial and contrived) without any evidence to support it. The Council had made a valid "quantum meruit" claim against DEFRA which had been settled by genuine negotiation, and reg.38 was the proper means of adjusting the VAT to reflect it.

First Tier Tribunal (TC01463): *Cumbria County Council*

<u>*Surprising decision?*</u>

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

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

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

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

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

The First Tier Tribunal did not consider that these arguments were well-founded, and as a result did not have to conclude on whether it had jurisdiction to consider them. The earlier compliance visits could not be relied on as an assurance that everything was well with the VAT accounting; the 2007 visit had only identified the

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problem because the officer had noticed an increase in Box 4 and tried to find out what had caused it. In the view of the FTT, there was no doubt that the claims should have been restricted to 7/47 of the "outstanding amount", which took into account the payment of the net figure by the insurance company. The appeal was dismissed.

The Upper Tribunal has overturned this decision and allowed the taxpayer's appeal. This is perhaps surprising – the application of fairness and "common sense" over the apparently clear wording of the legislation. HMRC may appeal further.

The judge considered that the way in which the consideration was invoiced meant that it was separated into two parts: the net amount, paid by the insurance company, and the VAT, due to be collected from the customer. The invoices to the customer, raised in accordance with instructions from HMRC, were therefore "only VAT". If they were not paid, it was clear that the bad debt related only to VAT. According to the purpose of s.36, that should be eligible for a bad debt relief claim.

The judge also distinguished between a "literal" construction of the legislation (on which basis HMRC would win) and a "strict" construction. Although they are often the same, a "strict" construction must also have regard to the purpose of the legislation and the context of the provision in dispute. Where the result of a literal construction is manifestly unfair and unsatisfactory, it is necessary to look further.

European case law has emphasised that only the final consumer is supposed to bear the cost of VAT; taxable persons are supposed to be able to recover input tax in full and therefore are neither advantaged nor disadvantaged by the tax which flows through their hands. The judge extended this principle to apply to output tax and bad debts. If the solicitors had to pay VAT to HMRC which they then did not collect from their customer, they bore a burden which was contrary to the purpose of the legislation. That had to be wrong. This was based on an application of the CJEU decision in *Elida Gibbs*.

The judge considered the European Convention on Human Rights and decided that it did not assist the appellant. He said that it was necessary to be cautious before applying human rights principles to taxation; he concluded that the charge would not be disproportionate, nor would it fail to strike a fair balance between the taxpayer and HMRC. However, he ruled that the technical argument based on the VAT Directive succeeded instead.

Upper Tribunal: *Simpson & Marwick v HMRC*

Contributed by Mike Thexton