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PERSONAL TAX

Were the payments, made to employees, emoluments?

The taxpayer company was the employer of the two employee taxpayers. It agreed to establish a joint venture (KNDL) with another company. Some 2000 employees, including the two employee taxpayers, were transferred to KNDL. Industrial action was threatened by the employees transferred. After several meetings, the taxpayer company agreed to make payments totalling £5,000 (payments of £3,000 (immediately) and £2,000 (a year later)) per employee in consideration of the loss of their pension rights. The instant dispute concerned the status of that payment.

The First-Tier Tribunal (Tax and Chancery chamber) (the FTT) found that the payments had been made to secure the motivation of the employees and to avoid strike action. It also found that the payments made to the employees had been emoluments from an employment, and therefore taxable. The taxpayers appealed against the tribunal's finding that the payment had been made to motivate the employees and to compensate them for lost pension entitlements, and against the consequent finding that the sum was taxable. The Upper Tribunal (Tax and Chancery Chamber) (the UT) dismissed the appeal and upheld the reasoning of the FTT. The claimant appealed to the Court of Appeal.

The issue was whether the UT had erred.

Decision:

The UT had been correct to dismiss the appeal. The FTT had not been wrong in law to find that the payments made to the employees had been emoluments from an employment. There had been no misdirection of law in the FTT decision. The correct statutory provisions had been set out. The key passages in the leading authorities had been cited or sufficiently summarised. Further, there had been no misapplication of law to the facts. There had been clear findings of fact that the payments had been made to avoid industrial action; that the threat of strike action had been a substantial cause of the payment; and that the payments had been in reference to the services of the employees rendered and in the nature of a reward, inducement or incentive to work willingly for the joint venture company in the future. Those facts had been sufficient to establish the necessary relevant connection or link between the payments and the recipients' employment and to justify the finding of the FTT that the payments had been emoluments from the employment. Furthermore, there had been no error of law in the judge reaching that conclusion, by reason of his having found that the payments had also been paid as compensation for pension loss. He had been entitled in fact and in law to conclude that the presence of the pension compensation factor in relation to the payments had not detracted from his overall conclusion characterising the payments as being in relation to employment services and therefore emoluments from employment. Accordingly there was no basis for disturbing the UT's decision. Decision of Newey J [2011] All ER (D) 160 (Jan) affirmed.

Comments – Where payments are received in circumstances that may potentially be received in compensation for the loss of a right rather than for the carrying out of duties as an employee careful consideration needs to be given to the actual nature of the receipt and whether there are different component parts which may necessitate different tax or NIC treatments.. Although the payment was being made because the employees regarded themselves as being disadvantaged (by moving from a final salary scheme to a money purchase scheme) the payment was being made, as found, in their capacity as employees. The CA unanimously upheld the Tribunal decisions that the payments were 'from' the employment and were therefore within the charge to income tax and national insurance contributions.

Kuehne & Nagel Drinks Logistics Ltd and others v CRC, Court of Appeal

Mileage allowances and salary sacrifice arrangements

Several associated companies carried on businesses as employment bureaux. They paid allowances to employees to cover travelling expenses. In 1998 a Revenue officer granted a dispensation under which the companies were not required to account for PAYE and NICs. HMRC subsequently formed the opinion that the dispensation should have not been granted, and in 2006 it revoked it. The companies continued to pay the allowances without accounting for PAYE, and in 2007 HMRC issued determinations under Income Tax (PAYE) Regulations, SI 2003/2682, reg 80. The companies appealed.

Decision:

The First-tier Tribunal reviewed the evidence in detail and dismissed the appeals, holding that the allowances were payments of earnings, intended to reimburse ordinary commuting expenses, and that the companies should have accounted for tax throughout the relevant period. The PAYE Regulations require employers to deduct PAYE from 'payments of earnings'. The Tribunal upheld HMRC's view that the relevant payments were 'earnings'.

The key point in the case was the employment tax treatment of a travel and subsistence arrangement that was purported to be a salary sacrifice arrangement. The First-tier Tribunal considered that daily payments Reed made to cover lunch and commuting to around 500,000 temporary workers between 1998 and 2006, did not constitute an effective salary sacrifice arrangement, as in reality no part of the salary was sacrificed. The tribunal judges said: 'The salary was paid in full, even if there was a later manipulation'.

In addition, it was ruled that the employed temps were engaged under a series of job-by-job contracts rather than under a continuing contract of employment. Consequently, each assignment should have been treated as a separate engagement to a permanent workplace with the allowances paid subject to PAYE provisions. This decision turned on the lack of clarity of the arrangements in place (including those agreements with HMRC). This led the Tribunal to conclude that a salary sacrifice was found not to exist. The tax and NIC, along with interest, has been calculated at £158m.

Comments - This decision from the First-tier Tribunal case of Reed Employment plc (and other Reed Group companies) v HMRC has far reaching ramifications for employers with salary sacrifice arrangements. Companies should use the case to review their current salary sacrifice schemes, making sure they are robust. The case highlights potential pitfalls around salary sacrifice and shows that employment contractual arrangements are as important as the tax considerations.

This decision makes clear that the starting point for any successful arrangements has to be a correctly worded and understandable contract of employment which, to be acceptable to HMRC, should be an overarching contract of employment. The revised employee package must also be communicated effectively, demonstrating the worker was in agreement and had all the information to understand the arrangements affecting him/her. All the facts should be on the table when dealing with HMRC and all parties should fully understand the arrangements in place with this being supported by clear employee communications.

Had this been the case here it would have aided the argument that the payment of tax-free allowances were made on the understanding that all parties agreed to this (including HMRC), even if this was later found to be wrong. This case potentially has far-reaching implications for all employers entering into salary sacrifice arrangements, which will all now need reviewing to ensure they are compliant and importantly that the workers and HMRC fully understand the arrangements they have entered into.

Reed Employment plc v HMRC (and related appeals) (No 4) (TC01727)

Payments to employee benefit trusts

A company entered into a tax avoidance scheme, devised by an accountancy firm and described as a 'discounted options scheme', with the aim of providing additional remuneration to seven of its employees without incurring liability to PAYE or NIC. The scheme involved payments into an employee benefit trust, which acquired 15 Isle of Man companies, and which purported to settle nominal sums on family benefit trusts for the relevant employees and to grant each of the family benefit trusts share options in one of the Isle of Man companies. The intention of the scheme was that there would be no UK tax charge on the cash held in the Isle of Man company until the cash was brought back to the UK (for example, by dividend or liquidation). HMRC issued determinations under Income Tax (PAYE) Regulations, SI 2003/2682, reg 80. The company appealed, contending inter alia that none of the seven employees had ever become contractually entitled to payment of or on account of any emoluments.

Decision:

The Upper Tribunal rejected this contention and dismissed the company's appeal. Warren J held that the shares transferred to the employees were 'readily convertible assets', and that arrangements were in place whereby the shareholders were 'enabled to obtain an amount of money' which was, or was likely to be, 'similar to the expense incurred in providing the shares'. Accordingly, the effect of the PAYE regulations was that the company was treated as making a payment of income of that amount, on which it should have accounted for tax.

Comments - The Upper Tribunal upheld the First-tier Tribunal decision that the scheme adopted here did not have the desired effect of avoiding liability to PAYE. Planning of this nature over recent years has had to become increasingly intricate to attempt to get round legislation dealing with the taxation of employment income as it has been tightened in successive Finance Acts. The width of the legislation its wording and its aim always needs to be considered. You should note that the most recent legislation - employment income from third parties - or the so called disguised remuneration legislation is deliberately written to be as all inclusive as possible.

Aberdeen Asset Management plc v HMRC (Upper Tribunal)

Were actors employees for NICs?

A television company had, until November 2006, treated several actors as employed earners and accounted for Class 1 national insurance contributions on the amounts it paid them. From December 2006 it ceased to account for Class 1 NICs, treating the actors as self-employed. HMRC issued determinations charging NICs on the payments.

The First-tier Tribunal issued a decision in principle that the company was required to account for NICs in respect of most of the types of contracts, except where the actors were 'engaged to perform a specific role in a specific programme, engaged for a specific period of engagement, and received a single total inclusive fee'. The company appealed to the Upper Tribunal

Decision:

The Upper Tribunal upheld the First-tier Tribunal decision. Sales J held that the effect of the standard 'bespoke agreement' was that 'an actor working under it is properly to be characterised as an employee for NIC purposes'.

Comments - The Upper Tribunal upheld HMRC's view that the actors were employees. The key issue was whether the payments received were salary as contributions are payable by 'entertainers' except those whose remuneration 'does not consist wholly or mainly of salary'. A sum will be salary if it is paid in respect of services rendered or to be rendered, and is payable under the terms of a contract, and is computed by time and payable at a fixed time, and is in respect of services which have an element of continuity or recurrence

ITV Services Ltd v HMRC (Upper Tribunal)

Share fisherman- employed or self-employed?

A share fisherman, who had worked on the same trawler from 2000 to 2009, had submitted tax returns indicating that he was self-employed, but subsequently formed the opinion that he should have been treated as an employee. He appealed against an assessment and an amendment which HMRC had issued on the basis that he was self-employed.

Decision:

The First-tier Tribunal allowed his appeal, specifically distinguishing the decision in Todd & Others v Adams & Chope, CA [2002] EWCA Civ 509. Judge Tildesley held that he had been 'employed under a contract of service'.

Comments - In most cases concerning the borderline between employment and self-employment, the appellant is contending that he is self-employed. This is an interesting case because the appellant successfully contended that he had been an employee. Judge Tildesley specifically distinguished Todd & Others v Adams & Chope, which HMRC had cited as an authority.

G Barney v HMRC (TC01695)

Glasgow Commonwealth Games 2014

The Treasury has announced that non-UK resident athletes at the Commonwealth Games will be exempt from income Tax, as with the London 2012 (SI 2010/2913) exemption. Without this exemption, any participant would be subject to income tax on their worldwide earnings.

With the major sporting events taking place in the UK in the near future – the London Olympics (Referenced above) and the Champions League Final in 2013 (legislation to be included in the FA 2012) this is the next event that needs to be considered.

Childcare tax scheme changes from 6 April 2011 **(Lecture P701 - 9.25 minutes)**

As we approach the end of the year, advisers will need to review how clients implemented the changes which came into force on 6 April 2011, and be ready to support them going forward.

Employers affected

The changes affects employers operating two types of scheme :

- Childcare vouchers
- Directly contracted childcare

The change does not affect employers operating workplace nurseries. These continue to be a tax free benefit without limit provided conditions are met.

Affected employees

The changes only affect employees joining schemes on or after 6 April 2011. Existing employees within a scheme can continue to benefit from marginal rate relief on their childcare support, but the change withdraws relief in excess of basic rate for new joiners.

"Existing employees"

To meet the definition of existing employees, the individuals must have submitted an application to the employer on or before 5 April 2011, and be eligible to receive tax and NIC exemption on that date. This means that the child must be born or placed for adoption at 5 April 2011 otherwise no tax and NIC exemption would be due. It is not necessary that the first voucher is provided by 5 April 2011, just that the individual has applied for the scheme and is entitled to the tax exemption.

If an employee is within a scheme but has a temporary break in vouchers they do not become "new members", provided the break is no longer than 12 months. This arrangement permits maternity leave, sick leave and other career breaks. The rules also ignore changes under TUPE and other mergers / reorganisations.

How it works

When an employee joins a scheme on or after 6 April 2011 the employer must carry out a "Basic Earnings Assessment". This is to establish their marginal tax rate for these purposes, and is carried out when the employee joins the scheme and annually at the start of the tax year thereafter. The amount computed is known as the relevant earnings amount.

Because the changes only apply to those joining schemes in the tax year just ending, it is likely that computing the relevant earnings amount has not so far been onerous for employers. However, as time goes on the requirement to recomputed this annually in early April (and at least before any vouchers are provided in the new tax year) to all post 6 April 2011 members of the scheme will become increasingly challenging.

Supporting affected employers as we move from 2011/12 to 2012/13 will be a key aspect of the adviser's work; you will need to ensure that affected employers realise that this must be done, the importance of timing and what must be included in the calculation of the relevant earnings amount. Employers should also be aware that they should document the process and take reasonable care, so that if there are mistakes, no penalties would apply.

Basic Earnings assessment

This is based on the information available at the time it is carried out; the assessment must not be delayed until P11D information is available. Once carried out it remains unchanged for the balance of the tax year, even if the financial position of the employee changes significantly. The assessment is used to determine how much the tax free allowance is for the year.

Records of the calculation must be made and retained for inspection, but there is no requirement to submit them to HMRC. The information used in the assessment is derived only from the current employment (irrespective of other employments held).

Relevant earnings amount

This is calculated for each tax year by first adding

- the amount of any relevant earnings for the tax year from that employment and
- any other amounts treated under Chapters 2 to 12 of Part 3 ITEPA 2003 as earnings from that employment (excluding any tax exempt benefits)

Then deducting

- the sum of any excluded amounts.

For this purpose, “relevant earnings” means any salary, wages or fees and any of the following:

- guaranteed contractual bonuses;
- contractual commission;
- guaranteed overtime payments;
- location or cost of living allowances;
- shift allowances;
- skills allowances;
- retention and recruitment allowances; and
- market rate supplements.

Where an assessment is carried out part way through the year, the previous pay and benefits already paid during the year must be ignored, and only the expected amounts for the balance of the year included in the calculation, and the amount scaled up to an annual amount.

There is some detailed guidance on this aspect on EIM16055.

Excluded amounts include pension contributions, payment through payroll giving, tax deductible expenses, removal expenses which are tax exempt and the standard personal allowance in the case of employees tested against the higher rate threshold. The blind person’s allowance should be deducted if it applies. This is covered in EIM16056.

Comparison

Compare earnings from the basic earnings assessment with the higher and additional rate thresholds of £35,000 and £150,000.

Table : tax free amounts 2011/12

	Basic rate and existing members	Higher rate	Additional rate
Weekly	£55	£28	£22
Monthly	£243	£124	£97
Annual	£2,915	£1,484	£1,166

Excess payments

One of the issues for employers is the potentially different treatment of excess amounts for tax and NIC purposes.

- Tax – include on P11D at the end of the year
- NIC – if excess vouchers then include in payroll and account for employer and employee NIC at the time provided
- NIC – if excess directly contracted childcare NIC is Class 1A and reported on P11D accordingly

EIM updates

The Employment Income Manual includes guidance on this change at EIM16050 onwards for vouchers, and EIM21900 for employer supported childcare. There is a consequential change on the page dealing with implementing salary sacrifice agreements on EIM42777.

Childcare schemes and salary sacrifice

The childcare legislation provides that the exemption is available only where all employees are offered the benefit is available to all employees on the same terms. Where an employer offers childcare vouchers in return for salary sacrifice this has an interaction with national minimum wage. Childcare vouchers do not form part of pay for minimum wage purposes, so employers would therefore be forced to exclude employees from a scheme if their salary sacrifice took them to below minimum wage. This of course would cause the scheme to fall foul of the availability rules.

Section 36 FA 2011 rectifies this issue by allowing employers to exclude "relevant low paid employees" from a scheme – with an appropriate definition. The change is backdated to 6 April 2005 when the scheme commenced.

Contributed by Rebecca Benneyworth

Taxation of company cars **(Lecture B701 – 9.34 minutes)**

Over the last few years there have been a number of changes affecting the taxation of company cars. Those with lasting relevance, or due to commence shortly include:

- Electric cars (known as zero emission cars) attract a zero benefit in kind for five years from 2010/11.
- Electric (zero emission) vans are similarly taxed at £0 for five years from 2010/11.
- From 6 April 2011 the cap of £80,000 on list price was abolished. [EIM23100, 23205]
- From 6 April 2011 all of the alternative fuel "discounts" were abolished. Cars are either taxed at the Table rate, or Table + 3% for diesel. Electric cars are dealt with separately.
- From 6 April 2012 the Table will be restructured so that it starts at 10%, which will equate to 99g/km and below. From there, 100g/km (up to 104g/km) will be taxed at 11%, 105g/km at 12% and so on. This has the effect of reducing the base figure (at which 15% benefit is applicable) further to 120g/km. The legislation to achieve this is included in Finance Act 2010 at section 59.
- Section 51 FA 2011 reduces the lowest emissions on the Table for company car tax from 100g/km to 95g/km from 6 April 2013. This will produce a 1% increase in applicable percentage for most drivers from that date.

Example : driver with car emitting 118g/km.

The list price of the car is £15,000. His current benefit in kind is calculated at 10% of list price as the car emits no more than 120 g/km. so for 2011/12 the benefit is £15,000 x 10% = £1,500. The tax bill for a basic rate taxpayer is £300, and for a higher rate payer is £600.

In 2012/13 this will rise to 14% of list price, a 40% increase. This brings the tax bill for a basic rate taxpayer to £420, and for a higher rate taxpayer to £840.

In 2013/14 this will rise again to 15%, bringing the tax bills to £450 and £600 respectively.

Zero emissions

This term was introduced by FA 2010, s 58. This replaces the term "wholly electric"which are now termed "zero emissions", defined as a car which cannot under any circumstances emit CO_2 by being driven. Similar changes have been made to the terminology in relation to vans.[EIM22790, 28450]

Other changes

Section 54 FA 2009 amends the calculation of list price of a car for a disabled driver (who is a holder of a blue badge). The list price is taken as the list price (or notional list price) of an equivalent model with manual transmission when the driver's disability means that he is required to use an automatic car. This brings the computation of list price in line with the CO_2 basis which already recognises this need. The change took effect from 2009/10. [EIM23011, 23137]

Section 58 FA 2010 introduced a new 5% rate of benefit in kind on cars emitting strictly no more than 75 g/km (this special rate will still be subject to the 3% addition for diesel vehicles). This new rate commenced on 6 April 2010 and runs for five years.

Statutory Mileage rates

The statutory mileage rates for use of own car on business journeys were updated in April 2011 – an unexpected but welcome change. The main rate applying to the first 10,000 miles in a car or van is now 45p per mile (from 40p). The rate for miles in excess of 10,000 is 25p. Amended examples have been updated in EIM31350 to 31375. Other rates are unchanged.

Fuel benefit scale charge

The fuel benefit scale charge increased to £18,800 for 2011/12. This is multiplied by the percentage used for the provision of the car, as adjusted for diesel or low emission cars. There has been no announcement yet about the level for 2012/13.

Fuel only advisory rates – effective 1 March 2012

Car fuel rates are now updated regularly based on current average fuel prices. Employers would be wise to bookmark the page and check back regularly. Current rates are on http://www.hmrc.gov.uk/cars/advisory_fuel_current.htm. Previous rates are shown on http://www.hmrc.gov.uk/cars/advisory_fuel_archive.htm

Table : rates effective 1 March 2012 until further notice

	Petrol	Diesel	LPG
Engine capacity	pence per mile		
Up to 1400 cc (1600 cc for diesel)	15	13	10
1400 – 2000 cc (1600 – 2000 cc for diesel)	18	15	12
Over 2000 cc	26	19	18

Planning points

There is no doubt that with the increasing tax charge on company cars there are many employees who will be feeling the pinch. The car as a tax efficient benefit in kind is probably not in existence any more, but the high mileage business driver still needs something for work use.

Although electric cars offer a tax free alternative, these remain very expensive to purchase, and the infrastructure for recharging for long business journeys is not rolled out, so this is an impractical alternative for those needing to travel nationally for work.

Hybrid petrol/electric cars possible offer the best choice, as these have low emissions and are moderate cost. There are cars due to come to the market in 2012 which will have emissions of only 45g/km, as they use the electric motor for motive power and the engine to charge the batteries. Fuel cell technology is also an interesting development, but will not be commercially available for some time.

For conventional cars, the advent of "stop/start" technology improves emissions significantly and for modest additional cost so this is worth exploring.

Clients may need reminding that aiming for the lowest possible emissions can result in a very significant list price, and their aim for tax efficiency should be to balance list price and emissions. For example, a Citroen C1 will be taxed at 12% of list price in 2012/13, but has a list price of around £8,000. A more fuel efficient model taxed at 10% would need to cost no more than £9,600 for this to be a better alternative – and if the lower emissions comes at a cost of diesel engine, then the rate would be 13% in any event.

Contributed by Rebecca Benneyworth

Change of HMRC policy on Smartphones **(Lecture P702 – 12.03 minutes)**

Since the emergence of smartphones into the consumer mobile phones market from around late 2007 onwards, HMRC has considered that they were to be treated in the same way as set out in its previously published guidance about personal digital assistants ('PDAs'). This view was based on the understanding that smartphones were not devices that are designed or adapted for the primary purpose of transmitting and receiving spoken messages and used in connection with a public electronic communications service.

Change of view

HMRC now considers that its application of the legislation to smartphones is incorrect.

HMRC now accepts that smartphones satisfy the conditions to qualify as 'mobile phones'. Developments in PDAs following the penetration of smartphones into consumer markets from late 2007 onwards mean that many modern consumer PDAs are now also likely to be smartphones. But this will not apply to devices that are solely PDAs.

It should be noted that this view applies to smartphones as configured and understood at the start of 2012. This is an area of rapidly changing technology and HMRC cannot be certain about the application of the definition of 'mobile phone' to new forms of smartphone.

It should also be noted that there are many types of devices that have telephone functionality which do **not** qualify as mobile phones. The definition does not cover apparatus that is designed or adapted for a primary purpose other than transmitting or receiving spoken messages, even if that apparatus is also capable of being used in this way.

Examples of apparatus that does not fall within the definition of a mobile phone include satellite navigation devices, devices that are solely PDAs and tablet and laptop computers. In general, devices that use Voice Over Internet Protocol ('VOIP') systems to make and receive phone calls will not satisfy the primary purpose test.

Guidance

As a result of the change of view set out above, the guidance at EIM21701, EIM21779 and EIM21780 is being updated. Amendments are also being made to the Expenses and Benefits A-Z and will be made in due course to booklet 480.

Employers

Where you provide a smartphone in 2011-12, treat it in the same way as any other mobile phone. Only include a benefit on form P11D for any mobile phones/smartphones that are either over and above the first one provided to the employee or that are provided to a member of the employee's family or household rather than to the employee personally.

If you provided a smartphone for 2010-11 and years back to 2007-08 you may wish to consider seeking repayment of the Class 1A National Insurance contributions (NICs) liability in relation to the benefit of the smartphone. Full details for the repayment process is within the full text of the Brief.

HMRC will use any employer repayment information to identify any repayments of Income Tax that may be due to employees. In order that HMRC can act on this information and make any Income Tax repayments to employees for 2007-2008 the employer should provide the information in respect of 2007-2008 to HMRC by 31 July 2012. The time limits for repayment of Class 1A NICs liability are later, so if you comply with the dates for Income Tax, you will be within any time limits for claiming a refund of Class 1A NICs.

If there are any affected employees for 2010-11 for whom the change of view on smartphones means you will not need to send a P11D for 2011-12 as there are now no benefits or expenses to report on it please send a separate list of the names and employees affected. Full details are provided in Brief 2/2012.

The Brief also contains full information concerning employee tax repayments.

Extracts from Revenue & Customs Brief 02/2012 Employment income - definition of mobile phone (treatment of smartphones, 20 February 2012

Tax-efficient giving through Gift Aid **(Lecture P703 – 8.58 minutes)**

With the tax year end approaching and many charities suffering from falling donations, it is a good time to be reminded of the tax-efficiency of the Gift Aid scheme.

A cash gift to a charity under Gift Aid is treated as if the donor had deducted basic rate tax before making the payment. Thus a payment of £80 represents a gift of £100 less tax at 20% and the charity can recover the £20 from HMRC.

For donors who are basic rate taxpayers, there is nothing further to consider, but, if the individual pays tax at the higher or additional rates, he is entitled to higher or additional rate relief on the gross amount of the gift. This means that a total amount of £100 received by the charity has a net cost of just £80 – £30 = £50 to a 50% taxpayer.

If the gift is made to a body such as the Charities Aid Foundation (CAF), the CAF will reclaim the basic rate tax and add it to the original gift (less a 4% commission), leaving the donor with what is effectively a bank account of charitable funds to distribute as he sees fit, ie. by standing order, cheque or online.

In terms of the remaining formalities, it is only necessary to complete a Gift Aid declaration which includes the donor's full name and address, the name of the charity and the amount of the donation. It must also state that the donation is being made under the Gift Aid scheme. The donor must additionally certify that he pays, in the tax year concerned, an amount of income tax and/or CGT which is at least equal to the basic rate tax deemed to have been deducted from the payment – otherwise HMRC are entitled to recover from the donor the tax which the charity has reclaimed.

It should be noted that a donor cannot carry a Gift Aid payment forward, but, by virtue of an election under S426 ITA 2007, it is possible to carry a donation back to the previous tax year (subject, of course, to the relevant conditions being satisfied for that year). Depending on the individual's particular circumstances, this may give him tax relief at a higher or lower rate, but, in any event, it should certainly provide him with earlier relief if he is a 40% or 50% taxpayer. The donor must make this election to HMRC prior to or simultaneously with the submission of his tax return for the preceding year (and no later than the appropriate self-assessment filing deadline).

An alternative to making a gift of cash is to give the charity quoted shares (including AIM shares) or land. This involves a rather different procedure and the effective rate of tax relief is usually much better. The rules can be found in Ss431 – 446 ITA 2007. Under this arrangement, income tax relief is given by deducting the market value of the asset transferred (together with any costs of transfer) from the donor's total income for the tax year. This is in addition to any relief under S257 TCGA 1992. However, it is not possible to carry this form of relief back to the previous tax year. Accordingly, if a wealthy client wishes to mitigate his 50% income tax liability for 2011/12, he must make the gift on or before 5 April 2012.

A useful planning point is that it will often be significantly more beneficial for the donor to make a charitable gift of, say, quoted shares which are standing at a substantial profit than to realise the gain, pay the relevant CGT and gift the net proceeds to the charity – see Illustration 1 below.

Illustration 1

Boris has an income in excess of £500,000 and he always makes use of his annual CGT exemption. He holds some quoted shares which have a negligible base cost but which are currently worth £100,000. He wishes to make a substantial gift to his favourite charity.

Boris has two alternative courses of action:

Sale of shares by Boris

In this situation, Boris will realise a gain of £100,000, on which he has to pay CGT of £28,000. This leaves him with net cash of £72,000 to give to the charity.

Under Gift Aid, the grossed up amount of the donation is 100/80 x £72,000 = £90,000. Boris will be entitled to additional rate relief on £90,000. This comes to:

(50 – 20)% x £90,000 = £27,000

The charity, on the other hand, is entitled to recover the tax treated as deducted at source and so the £72,000 gift will be worth £90,000 in the hands of the charity.

Gift of shares to charity

Alternatively, Boris can donate his shares to the charity. This will be done on a no gain no loss basis. The charity can then sell the shares for £100,000 and keep the full sale proceeds.

Boris will be entitled to 50% tax relief for the value of his gift. In other words, he can claim a £50,000 reduction in his income tax liability.

The comparison below indicates that Boris should opt for the latter course of action:

	Tax saving for donor	Proceeds enjoyed by charity
(i)	£27,000	£90,000
(ii)	£50,000	£100,000

Contributed by Robert Jamieson

Offshore bank accounts – current HMRC activity **(Lecture P705 – 12.47 minutes)**

John Cassidy, tax investigations partner at PKF (UK) LLP, outlines HMRC's latest activity aimed at generating additional tax from funds held offshore. Perhaps surprisingly, there could be a significant burden on complaint taxpayers as well as those with irregularities to declare.

Introduction

The spate of tax amnesties in recent years started with two relating to offshore issues; being the Offshore Disclosure Facility (ODF) in 2007, followed by the New Disclosure Opportunity (NDO) which finished in 2010. More recently, we have seen the Liechtenstein Disclosure Facility (LDF) which runs until 2016 together with the rather penal withholding tax regime under the UK/Swiss tax agreement due to come into force in January 2013.

So where does that leave the UK taxpayer who holds accounts offshore, either for tax planning, personal or tax evasion reasons? As well as providing facilities enabling taxpayers to declare previously unreported income and gains, HMRC has been very busy working alongside those initiatives on projects aimed at finding previously underpaid tax. The downside is that an onerous burden may well be placed on compliant taxpayers in order to ensure that offshore funds are not – unjustly – heavily taxed.

HMRC's Offshore Coordination Unit (OCU)
The OCU was formed at the end of 2011 and is being funded out of the £900m set aside for compliance work in the Comprehensive Spending Review. Its role is to coordinate all work on offshore compliance matters, so it will have a hand in any projects of this nature. Its scope will not be restricted to the Swiss initiative, but will cover various disclosure opportunities including the LDF. As part of that, it is looking to develop innovative intervention techniques and approaches.

The OCU is based in Birmingham under the Specialist Investigations banner, with 25 staff (of various grades and skills) to start with but expected to increase rapidly to 100.

What activities can be expected?

As noted above, the OCU will be developing new, innovative methods of using all the offshore information which HMRC has gathered. That is a significant amount of data - reportedly about 80 times more data than is held by the British Library.

In 2006, HMRC obtained data from Barclays Bank about offshore accounts linked to customers with UK addresses. That led directly to the ODF. After some limited follow up activity, HMRC widened its targets significantly and collected a vast amount of similar data from over 300 banks, which led to the NDO.

Since the NDO, the reality is that little has been done with that data – until now. The OCU will be sifting through it with a view to unearthing unknown bank accounts in, say, Switzerland, and other overseas jurisdictions.

That exercise will no doubt provide numerous leads for HMRC's investigators. However, that is just the start. For example, the OCU will also be looking at improving the ways in which HMRC utilises the significant amount of information obtained under the EU Savings Directive. In addition, while HMRC may find it difficult to access Swiss bank accounts directly, the funds in any overseas account must have come from somewhere and are often paid on to somewhere else. There is also the distinct possibility of obtaining intelligence from the land registry, both in the UK and overseas, to consider as well as what else the funds may have been spent on such as investments. The point is that there are plenty of documented audit trails which HMRC is expected to follow now that the OCU is in place; it is not too difficult a task to cross reference intelligence in the IT age.

Then there is the issue of stolen data disks. Most famously, an employee of HSBC Geneva illegally downloaded details of clients of the bank and the disk eventually found its way to HMRC. Irrespective of any arguments about making use of stolen data, the fact is that HMRC had details of thousands of UK residents with Swiss bank accounts. The OCU has been at the forefront of making rapid and aggressive use of that data. While HMRC has stated that it will not actively seek further disks, it has also stated that it will gladly accept them if offered. It would be naïve to think that this might not happen again and there have been reports and rumours of other such activity.

Letters from the OCU
Numerous cases have been identified by HMRC and several thousand letters were issued last year to individuals known to hold an offshore bank account. The letters placed a burden on <u>all</u> such account holders, whether there was a tax problem or not. A choice of three responses was given, which are, broadly:

- certify that, although an offshore account is held, the individual is fully UK tax compliant;
- use the LDF;
- do nothing.

Certification under the first bullet point above was not restricted to the offshore bank accounts in question but related to the taxpayer's worldwide assets. In addition, it does not include a "to the best of my knowledge and belief" caveat, hence it is a very onerous signature, especially for a non-UK domiciled taxpayer whose overseas interests (that are none of HMRC's business) might be considerable. However, refusal to sign off on that basis has led to HMRC digging its heels in.

The choice is easier for the non-compliant taxpayer – either continue to bury your head in the sand or make a disclosure, perhaps using the LDF.

Code of Practice 9
Other individuals were contacted by the OCU with a different letter taking them straight into Code of Practice 9 (used for cases of suspected serious tax fraud).

On the face of it, non-compliant individuals have been found out and must now pay the price in terms of tax of up to 20 years, interest, hefty penalties and professional fees. However, some of the Code 9 letters were issued to compliant taxpayers, giving them no option but to take some sort of expensive action or wait for the inevitable estimated discovery assessment and spend time, funds and stress refuting it. For example, non-UK domiciled individuals with little reported income on their UK tax returns but significant funds in a Swiss bank account have been targeted, even though, for such individuals, the reported income and gains in the UK will very often bear no correlation to overseas wealth.

The point, however, is that recipients of such challenges from HMRC will, whether by formally asking for certification that all is well or by issuing Code 9, all have to take some sort of action, whether compliant or not. HMRC expects this to include a full explanation of the overseas bank accounts, submission of copy bank statements, and proof of the source of funds. This is despite assurances given by Dave Hartnett to the professional bodies in 2008, when the remittance basis changed, for example:

“The intention is that those using the remittance basis will not be required to disclose the source of those remittances”

“Those using the remittance basis will not be required to make any additional disclosures…… they will not be required to disclose information on the source of the remittances”.

UK/Swiss tax agreement – more work for the compliant

The UK / Swiss agreement was revealed last October and is due to come into force from January 2013. It is extremely complex, full of ‘shades of grey’ and easily enough material for a seminar in its own right.

The agreement creates a withholding tax for UK residents with a Swiss bank account (and certain other types of asset), which is designed to ensure that tax is collected from otherwise untaxed funds. However, the agreement applies to **all** Swiss bank accounts even if those accounts are clean, ie they do not contain untaxed (but taxable) funds. Hence even though there may be no tax problems, anyone holding such an account will have to take some sort of action if the penal withholding taxes are to be avoided.

The withholding taxes will be automatically levied at 19 - 34% of the **entire funds** in the Swiss accounts, as well as future withholding taxes on income and capital gains.

The position for those not domiciled in the UK is particularly difficult. If fully compliant, the way to avoid the withholding tax is either to formally opt out, on the basis that there are no untaxed monies in the accounts, or to authorise the Swiss bank to disclose the existence of the accounts to HMRC. The second option obviously removes any privacy and, as noted above, could lead to all sorts of questions about the provenance of the funds.

Moving forward, a withholding tax will be levied on all income and gains that the bank can identify as having been remitted to the UK. There is no opt-out to escape this. Non-UK doms will also need to take further action in that, annually, they will need inform the bank of an intention to claim non-UK domicile status along with the remittance basis before the tax year starts and then get a formal certification of the position (from PKF or another suitably qualified professional firm) after the end of the tax year. So, more hoops to jump through.

Tainted offshore funds?

Anyone with a Swiss bank account but no tax irregularities must still take action if the default position of withholding tax is to be avoided. Individuals who have not correctly disclosed income and gains from Swiss or other overseas accounts and other assets on their UK tax returns should seriously consider coming clean on past tax irregularities In many cases, individuals can bring their tax affairs fully up to date at a relatively low cost using the LDF. Contrary to what some advisers think, the LDF remains open for another 4 years and there is no need to currently hold a Liechtenstein asset. The taxpayer will achieve greater certainty on past years and the LDF will usually cost less than the Swiss withholding tax or normal disclosure routes. It will certainly be less stressful as HMRC takes a back seat while the disclosure report is prepared.

The UK/Swiss Agreement will not draw a line under the past in its entirety, nor will it guarantee immunity from prosecution. The LDF does both and in my view, for those clients who fit its conditions, that makes the LDF the only sensible route if there are tainted funds to declare.

The alternative is to wait for HMRC to investigate, which is becoming ever more likely given its renewed vigour in this area, which will be both stressful and costly.

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CAPITAL TAXES

Rollover relief: whether land occupied for trade

A trading company (P) had purchased a farm in 1990, and used it as its premises until 2000. It then sold the farm for £600,000 and purchased a replacement property for £354,900. P's directors moved into the new property, and P claimed rollover relief in respect of part of its gain on the sale of the farm. Following an enquiry, HMRC issued a closure notice on the basis that 95% of the new property was used for non-trading purposes, so that only 5% of the purchase price (ie, £17,745) could be treated as qualifying for rollover relief. P appealed.

Decision:

The First-tier Tribunal reviewed the evidence and allowed the appeal in part, finding that most of the property was occupied by P's directors, and that P was only the occupier of that part of the house which was used as an office, and of various outbuildings which were used for storage and packing. The effect of TCGA 1992 s 156 was that only those parts of the house 'which were actually used for selling are to be treated as both used and occupied by the company for the purposes of its trade'. TCGA 1992 s 152(11) required an apportionment of the purchase price in order 'to estimate what would have been paid for the separate parts of the property'.

On the evidence, the Tribunal held that £270,000 of the purchase price was attributable to the house and that only 10% of that could be treated as attributable to the part which P used as an office. Additionally, £40,000 of the purchase price should be attributed to the outbuildings which P used for storage and packing. The result was that £67,000 qualified for rollover relief.

Comments - TCGA 1992 ss 152–160 provides for 'rollover relief' on the replacement of business assets, subject to certain conditions. On the facts here, the Tribunal found that only part of the company's gain had been reinvested into the new premises, and that only a small part of those premises were actually used for the purposes of the company's trade. The result was that, of the £354,900 which the company had spent to acquire the premises, only £67,000 qualified for rollover relief.

PEMS Butler Ltd v HMRC (TC01769)

Mansworth v Jelley capital losses

HMRC have published a letter setting out a revised position in relation to capital losses on disposals of shares acquired on the exercise of employee share options before 10 April 2003. HMRC now state that, where the shares are treated as having been acquired at market value, the market value “is the full measure of their deemed cost of acquisition”. There is no deduction for any amount that is chargeable to income tax on the exercise of the option. If you have clients to whom this may still be relevant you should examine the letter in detail.

Business property relief is due on an FHL!

The deceased, Nicolette Vivian Pawson, partly owned a cottage, 'Fairhaven', near the seaside resort of Thorpeness, Suffolk, typically letting it out for one or two weeks at a time. Members of her family also occupied the cottage for three weeks during the holiday season, but they paid rent calculated with reference to HMRC's literature on payments for private use.

The following services were provided to the holidaymakers who stayed at the cottage:

- Use of a television and telephone.
- The property was cleaned before each letting and the garden was attended to.
- The property was fully furnished and heated. The hot water was turned on before visitors arrived and the kitchen was fully equipped.
- A cleaner/caretaker inspected the property regularly and bought cleaning materials for the cottage. Repairs were made as required.
- Clean bedclothes were arranged through a laundry service (but this service only started after Mrs Pawson's death).

Specific reference was made to the fact that the property had been advertised, although this had not kept up with modern developments, such as advertising on the internet. Evidence was provided by an estate agent who stated that, in her opinion, holidaymakers paid a premium rent compared to longer-term tenants because of the value of the services provided.

In the three financial years prior to Mrs Pawson's death, a profit was made in all but one year. The loss in that year was as a result of substantial expenditure incurred in decorating and improving the property and had it not been for this expenditure a profit would have been made in that year too.

The tribunal considered the following issues:

- did the operation of the holiday cottage constitute a 'business'; and
- if it did, was the business one which consisted of the holding of an investment?

Decision:

The First-tier Tribunal accepted that the property had been run as a business for more than the two years before the deceased's death. The fact that the family had use of the property for three weeks a year did not prevent it from being run as a holiday let. The business had been profitable for two of the three years before the taxpayer died, and was running profitably in the year of her death. The tribunal concluded the business was being run with a view to gain which satisfied IHTA 1984, s 103(3).

The tribunal then had to consider whether the business was one which consisted wholly or mainly of the holding of an investment. Taking into account the decision in George & Loochin (Stedman's Executors) v CIR [2004] STC 163, the judge concluded that 'an intelligent businessman would not regard the ownership of a holiday letting property as an investment as such and would regard it as involving far too active an operation for it to come under that heading'. He said that having to find new occupants and provide the relevant services were not the equivalent of owning a property as an investment. The property was a business asset being used to provide a service.

The taxpayer's appeal was allowed.

Comments – Business property relief is an important relief as it can give 100% or 50% relief from IHT depending upon the assets involved. Accordingly this case focused on the two important questions relating to whether there was a business and if there was what wasthe nature of that business. It is clear from the various additional actions and facilities provided that there was a business being carried on even though personal benefit was being derived from the property and that one year generated a loss rather than a profit.

This case provides a useful additional authority demonstrating that the more services and actions that are undertaken the less likely HMRC are likely to be in arguing that the business is that of the making or holding of investments. The additional activities the case referred to were strong indicators of a business not being the making or holding of investments and so they proved to be in this case. This demonstrates the importance of preparation of the argument in advance of the hearing so the evidence is clear to demonstrate the taxpayer's argument.

N V Pawson (deceased) (TC1748)

IHT: 'agricultural property'

A farmhouse was occupied by the son of the settlor until his death in 2002. HMRC issued a notice of determination charging IHT on the property. The trustee of the settlement appealed, contending that the farmhouse qualified for agricultural property relief.

Decision:

The First-tier Tribunal accepted this contention and allowed the appeal. Judge Walters declined to follow obiter dicta of the Special Commissioner in Rosser v CIR [2003] SSCD 311, and held that the effect of IHTA 1984 s 115(2) was that 'cottages, farm buildings and farmhouses in the third limb of the definition must be of a character appropriate to agricultural land or pasture (including woodland and any building within the second limb of the definition) in the same occupation, but that it is not required that the cottages, farm buildings and farmhouses should be in the same ownership as the agricultural land or pasture (as expanded by the second limb of the definition)'.

Comments - IHTA 1984 s 115 defines agricultural property as including 'any building used in connection with the intensive rearing of livestock or fish' if the building 'is occupied with agricultural land or pasture and the occupation is ancillary to that of the agricultural land of pasture; and also includes such cottages, farm buildings and farmhouses, together with the land occupied with them, as are of a character appropriate to the property'. This is an important decision because the Tribunal specifically rejected HMRC's long-held interpretation of the 'ownership condition'. HMRC took the view that the farmhouse here did not qualify for relief because it was not in the same ownership as the farmland. Judge Walters held that the legislation should not be interpreted as requiring this. It seems likely that HMRC will appeal to the Upper Tribunal.

JN Hanson (Trustee of the William Hanson 1957 Settlement) v HMRC (TC01791)

Too late to claim

The taxpayer's mother, Mrs Wyld, owned and lived in a property which was placed in a discretionary trust, with the aim of saving inheritance tax. The main beneficiaries were her two children. Mrs Wyld was treated as having reserved a benefit over the house. The whole value of the property was therefore subject to inheritance tax on the basis that the transfer into the trust had been a gift with reservation.

The son moved into the property after the mother died in August 2004. He obtained a valuation from the district valuer and agreed to buy it for £325,000. As part of the purchase agreement, he would pay his sister (the appellant taxpayer) her half share and also indemnify her against further capital gains tax.

In 2008, HMRC wrote to the appellant saying they believed she had disposed of a residential property in 2005/06 but she did not appear to have reported this to the tax office. The tax officer said that regardless of any indemnity, the liability for capital gains tax was her responsibility and she should complete a tax return for that year. There was some confusion over who had authority to act for the taxpayer, but the return was submitted. In 2009, HMRC issued a notice of surcharge for the late payment of tax, against which the taxpayer appealed.

The taxpayer's adviser claimed that HMRC had previously agreed verbally that no penalties or surcharges would made. After some procedural complications, which were eventually sorted out by the Upper Tribunal (Tax and Chancery Chamber), the case was remitted to the First-tier Tribunal.

Decision:

The tribunal judge considered whether the details about the property included in the taxpayer's return were correct — was the valuation prepared correctly? In essence, it had been calculated on the basis that the acquisition cost of the property was that when it was put into the trust, and the disposal proceeds were calculated as half the probate value on the mother's death.

If the trust were valid, the capital gains tax on the property being appointed to the beneficiaries would have fallen to the trustees, whether they were the taxpayer, or some other individuals. The gain would have been calculated on the difference between the acquisition value and the value at the date of the appointment. This would not necessarily have been the same as the probate value.

If the trust were not valid, the property would have remained in the mother's estate, and then have been transferred at probate value to the beneficiaries of the estate. This would have given them a base cost for capital gains tax purposes according to their share of the estate, which could be presumed to be equal between the brother and sister.

In either case, the gain made by the taxpayer would have not have exceeded the annual capital gains exempt amount for the relevant year.

However, even if it were necessary to correct the return, it would not be possible as it was out of time. Claims made on or after 1 April 2010 for a repayment of tax under TMA 1970, Sch 1AB para 3 can be made no more than four years after the end of the relevant tax year. In the taxpayer's case, the year was 2005/06 which was too late.

Given that the return could not be corrected, the tribunal had to deal with the liability arising on the figures in the return. The judge concluded that the tax charged was correct on the basis of the return submitted. The taxpayer did not have reasonable excuse for paying the tax late, as she should have sought help in dealing with her tax affairs sooner than she did. This amounted to neglect. The surcharges therefore stood.

However, the judge added that while HMRC's actions in the case had not been perfect, neither had the taxpayer 'been well served by any of her advisers … nor by the appeals system before these tribunals'. Had the matter been properly considered in 2008, the return could have been corrected. Overall, he concluded that 'the whole matter had been very unfortunate'.

The taxpayer's appeal was dismissed.

Comments – This case demonstrates how important it is when dealing with capital transactions to consider all the taxes that may be relevant and the obligations that may be relevant. Clearly the taxpayer needs to have appropriate advice on the transactions, their execution and the consequences thereof. It is apparent from the judge's comments that the taxpayer was not so best served.

Cherie Smith (TC1436)

The new rules for IHT and charitable legacies **(Lecture P704 – 29.44 minutes)**

On 6 December 2011, the Government published draft legislation intended to provide a useful new IHT relief where a deceased person's estate contains substantial charitable legacies.

In relation to deaths occurring on or after 6 April 2012, where an estate includes charitable legacies of at least 10% of the 'net estate', the death rate tax charge will be reduced from the normal 40% to just 36%. For these purposes, an individual's 'net estate' is the value of his estate excluding the available nil rate band (any transferable nil rate band must of course be taken into account), IHT exemptions and reliefs such as the spouse exemption under S18 IHTA 1984 and business property relief, but not the value of the charitable legacies themselves.

Legacies where the property is settled on trust will also count provided that the trust assets can be used for charitable purposes only.

As mentioned in above, the reduced rate of IHT will apply where 10% or more of the deceased's taxable estate is left to charity. The value of the estate on which the 10% calculation is made – this is known as the 'baseline amount' – is the value of the net estate charged to tax after deducting any available exemptions (other than S23 IHTA 1984), reliefs and nil rate band. It is important to appreciate that this reduced rate does not just apply to assets transferred under the deceased's will but can also be in point for other assets on which IHT is payable on death. When making these calculations, the estate is divided into three component parts. These are referred to as:

(i) the survivorship component;

(ii) the settled property component; and

(iii) the general component.

The survivorship component comprises any jointly-held property which passes by survivorship or some similar provision. These assets will typically be bank accounts or land and buildings owned as joint tenants.

The settled property component is made up of all the settled property in which the deceased had a life interest or a right to income immediately before his death, eg. pre-FA 2006 interest in possession settlements and immediate post-death interest trusts under S49A IHTA 1984.

The general component covers all the assets in the deceased's estate for IHT purposes other than the survivorship component and the settled property component above and any gift with reservation (GWR) property. Bear in mind that GWR property, although caught on the donor's death, was actually given away by him during his lifetime and is not therefore, strictly speaking, part of 'his' assets.

The total value of the deceased's charitable legacies is compared with 10% of the 'baseline amount' of the component from which the legacies come and, provided that the 10% test is satisfied, the lower rate of IHT then applies to that component. Where the charitable legacies represent more than 10% of the value of the component, it will be possible to make an election to merge that component with one or both of the others so as to extend the 36% rate to a greater part of the estate.

This is subject to the proviso that the charitable legacies must at least equate to 10% of the value of the merged components.

Illustration 1

Edward died on 1 May 2012, never having married and leaving free estate valued at £950,000 to his only nephew. Edward's unused nil rate band is £325,000.

Edward's free estate represents his general component. His taxable estate for IHT purposes is £950,000 – £325,000 = £625,000. At 40%, the estate's IHT liability is £250,000 and so the nephew would inherit £950,000 – £250,000 = £700,000.

In order to qualify for the 36% rate, it would be necessary for Edward to leave at least £62,500 to charity. If he did this, his chargeable estate would become £625,000 – £62,500 = £562,500 and the IHT bill would be 36% x £562,500 = £202,500. This gives a distribution of Edward's estate as follows:

	£
HMRC	202,500
Charity	62,500
Nephew	685,000
	£950,000

In other words, the cost of the £62,500 legacy is split as to £47,500 from HMRC and as to £15,000 from the nephew.

An important point to mention is that chargeable transfers made during the seven years prior to death will reduce the available nil rate band. The 'baseline amount' for the purpose of calculating the 10% requirement will therefore be greater.

Although the 36% rate will apply to any component which qualifies, those which do not will be subject to the normal 40% charge.

An illustration of the merger election referred to above is set out below. This election must be made by notice in writing to HMRC within two years following the death (Para 9(1) Sch 1A IHTA 1984).

Illustration 2

Take the same facts as in Illustration 1. However, on this occasion, Edward also owns a half-share of a property as a joint tenant and he has a life interest in a family trust set up by his late father many years ago.

Edward's share of the property is valued at £200,000 and his interest in possession is worth £150,000.

The value of Edward's estate is now £950,000 + £200,000 + £150,000 = £1,300,000. Deduct his nil rate band, which must be apportioned pro rata across the general component, the survivorship component and the settled property component, and this leaves £975,000.

In order to qualify for the 36% rate on his free estate, Edward would have to bequeath at least £71,250 from this component to charity (10% x £(950,000 – 237,500)) – note that the other parts of the estate would still be taxed at 40%. However, if, under the terms of his will, Edward left £97,500 or more to charity, an election could be made to aggregate the value of all three components and the whole taxable estate would then be subject to the reduced rate.

The relief will apply to charitable legacies created by will or under a deed of variation. In respect of the latter, the reduced rate will only be in point if it is shown that the charity in question has been notified that the distribution of the estate has been varied in its favour (S142(3A) IHTA 1984).

The main beneficiary of these new provisions is intended to be the charitable sector which, it is hoped, will now attract greater financial receipts. However, where individuals are already planning to leave charitable legacies amounting to 4% or more of their taxable estate, it will be advantageous to increase any such legacies to 10% given that there will be no additional cost to the testator's legatees. In other words, he can leave more to charity without reducing the amount available to his heirs. This can be proved in a straightforward way. Imagine that someone has property worth £550,000. He has a nil rate band of £325,000 and, apart from a charitable legacy of £9,000, everything else is left to his brother. IHT on this estate will be 40% x £(550,000 – 325,000 – 9,000) = £86,400. The estate will be distributed as follows:

	£
HMRC	86,400
Charity	9,000
Brother	454,600
	£550,000

If the testator increased his charitable legacy to £22,500 (so that the reduced rate would apply), the distribution becomes:

	£
HMRC (36% x (550,000 – 325,000 – 22,500))	72,900
Charity	22,500
Brother	454,600
	£550,000

Thus the increased charitable legacy has been wholly paid for by a reduction in the IHT liability – which is a very satisfactory state of affairs!

But it can get better than this. Sometimes it is possible to increase both the amount of the charitable legacy and the distribution to the deceased's family – see Illustration 3 below.

Illustration 3

Donald has an estate worth £1,200,000 at the time of his death. He leaves £600,000 to his widow, £25,000 to the RSPCA and the residue to his son.

On the assumption that Donald has a nil rate band of £325,000, the 'baseline amount' of his free estate is:

		£	£
Total assets			1,200,000
Less:	Spouse	600,000	
	Nil rate band	325,000	
			925,000
			£275,000

10% of this comes to £27,500 and so the rate of IHT on the residuary legacy to the son is 40%.

The distribution of Donald's estate is:

	£
HMRC (40% x (1,200,000 – 600,000 – 25,000 – 325,000))	100,000
Spouse	600,000
Charity	25,000
Son	475,000
	£1,200,000

If Donald increased his RSPCA bequest to £30,000, the estate will now qualify for the reduced IHT rate and the distribution becomes:

	£
HMRC (36% x (1,200,000 – 600,000 – 30,000 – 325,000))	88,200
Spouse	600,000
Charity	30,000
Son	481,800
	£1,200,000

The RSPCA receives an extra £5,000, the son receives an extra £6,800 and HMRC's entitlement falls by £11,800.

Over the next few months, individuals should consider reviewing their current IHT exposure and the terms of their existing wills, especially where they have already left reasonably substantial charitable legacies (albeit not enough to qualify for the 36% rate). In addition, married couples should examine their wills together in order to ensure that any charitable legacies are only made on the second death, given that the benefit of the IHT reduction could be lost if a deceased person's estate is otherwise spouse-exempt.

Contributed by Robert Jamieson

The Society of Trust and Estate Practitioners (STEP) has drafted a model clause for wills for use by individuals wishing to leave a legacy which will qualify under the proposed new provisions. The draft model clause is contained in a STEP press release, available at www.step.org/news/press_releases/2012/step_creates_model_clause_for.aspx.

ADMINISTRATION

P11Ds submission – Lack of information is no excuse

The taxpayer company's 2009/10 employer return P35 was filed online on time, stating that no forms P11D or P11D(b) were due. Two forms P11D for the year were however sent to HMRC in March 2011, and a form P11D(b) submitted in April 2011. HMRC issued a penalty for £900 as the P11D returns should have been received by 6 July 2010.

The company appealed.

HMRC queried why the company was unaware, when the form P35 was completed, that a P11D and P11D(b) were also needed. The company's explanation was that the two brothers who owned it had fallen out, and information had gone astray which caused problems with paperwork and administration.

Decision:

The First-tier Tribunal noted the company's problems, but said these did not constitute reasonable excuse. The company could have contacted HMRC to discuss the difficulties, but did not do so. While it had always filed its returns on time during the many years it had been in business, this did not of itself provide reasonable excuse for the lateness of the 2010/11 P11D forms.

The taxpayer company's appeal was dismissed

Comments – This case demonstrates the importance of knowing in a timely fashion what benefits need to be reported both on a correct and timely P11D as penalties exist for both incorrect returns and late returns.

Rowland May Ltd (TC1680)

Unexplained postal delays mitigating PAYE penalties

On 28 May 2010 HMRC sent a standard warning letter to the appellant informing it that it had not paid a PAYE payment for 2010–2011 on time and that it might be liable to a penalty if it made another late penalty in that tax year. In June 2011, in accordance with the new regime under FA 2009 Sch 56 HMRC issued a penalty notice charged at four per cent of the appellant's late paid PAYE (excluding the first default) on the basis that eleven payments were made between 5 and 34 days late, and that was the correct rate under FA 2009, Sch 56 para 6(7). The total amount of the penalty was £2,661.31. The appellant appealed contending, inter alia, that, although a number of payments had been made late, the cheque for payments between the months June to September had been sent first class post to HMRC predating the due date for payment. By way of example, the June payment had been sent on 14 June 2010 but not received by HMRC until 22 June, and the August payment was sent on 16 August but received on 1 September. The issue arose as to whether there was a reasonable excuse—within the meaning of FA 2009, Sch 56, para 16—for the defaults during those months based on the postal delays.

Decision:

FA 2009 was clear; except in the case of special circumstances—as defined in FA 2009 Sch 56, para 9—the statute gave no discretion over levying a penalty, given the use of the word “must” in para 11. The rate of the penalty was set by the number of PAYE late payments in the tax year. The amount of penalty was, therefore, only affected by the appellant showing that a reasonable excuse, for the purposes of para 16, existed. On the facts, the four per cent penalty rate was correctly charged, there having been eleven late payments. However, the June to September payments were made prior to the due date and by first class post and thus sufficient time had been allowed for the payments to reach HMRC in time, and the appellant had a reasonable expectation that such would be the case. Accordingly there was a reasonable excuse for the defaults during those months; namely postal delays over which the appellant had no control. It followed that the appeal would be allowed in respect of those months but dismissed in relation to the remaining months, as no grounds for reasonable excuse were advanced in respect of them.

The taxpayer's appeal was allowed in part.

Comments – Although the introduction of penalties for late paid PAYE was well trailed in 2010 we are starting to see cases come through. Although the first ones demonstrated the inflexibility of the regime and the potentially significant penalties we are also starting to see cases where reasonable excuse may be validly or partially validly claimed. It is important that even if there appear to be valid penalties capable of being levied diligence in tracking payments and properly allocating payments may significantly reduce those penalties. You should note that in both this case and the Dudman case referred to in last month’s notes the appeal has being partially successful with the right evidence. There is of course no substitution for paying the PAYE over at the correct time.

Crowson (trading as Mackenzies Smoked Products) (TC1623)

Right of Appeal – Procedure for disputing loss claims

The instant proceedings arose out of the taxpayer's 2007–08 tax return, which he was required to complete by the usual statutory notice. In December 2008, the Revenue and Customs Commissioners (the Revenue) produced a tax calculation showing an income and capital gains tax liability of £211,927. In January 2009, the taxpayer's advisers amended his return in a number of respects. In particular the pages dealing with “additional information” were amended. The taxpayer made a claim for employment loss relief under s 128 of the Income Tax Act 2007 (the 2007 Act). The taxpayer's claim involved 2007–08, as the year in which relief was claimed, and 2008–09, as the year in which the loss was incurred. On 30 January, the taxpayer's accountants informed the Revenue that, as a result of the relief claimed, no further 2007–08 taxes would be payable by the taxpayer. In March, the Revenue notified the taxpayer that it intended to enquire into his claim for loss relief under Sch 1A of the Taxes Management Act 1970 (the 1970 Act). In June, the Revenue commenced proceedings in the county court against the taxpayer, seeking to recover tax payable according to his return on the basis that the claim for relief was left out of account. The taxpayer challenged the court's jurisdiction and the matter came before the High Court.

The taxpayer contended that he had made an effective claim in his return, as amended, and that any enquiry had to be made under s 9A of the 1970 Act (the s 9A procedure). If the Revenue had followed that course, the taxpayer would have had a right of appeal in the first instance to the First-tier Tribunal to the exclusion of any court. The Revenue contended that by virtue of s 128(7) of the 2007 Act and para 2 of Sch 1B of the 1970 Act the taxpayer was not entitled to make a claim in his 2007–08 tax return for loss arising out of the income loss incurred in 2008–09. As the information provided by the taxpayer did not “relate” to the period for which the tax return was prepared, it was not properly to be treated as part of it. Accordingly, the taxpayer should have made his claim either in his 2008–09 return or have made a separate “stand alone” claim. On that basis, the Revenue submitted that it was the procedure in Sch 1A to the 1970 Act that should be followed to challenge a claim. The judge accepted the Revenue's arguments. He held that the s 9A procedure applied to any claim that might be included in a return and that it did not apply if the claim had to be made in any other way. In such circumstances, the court had jurisdiction to determine in collection proceedings whether a taxpayer was entitled to include in his return a claim for relief and so rely on it as a defence. The taxpayer appealed.

He contended that the s 9A procedure applied to any claim actually made in a return.

Decision:

If the Revenue decided to challenge matters contained in the return in response to the boxes provided, it had to use either the s 9A procedure or seek to make a correction to the return under s 9ZB of the 1970 Act, if applicable. That was so even if, under the relevant statutory provisions governing loss relief claims, that claim could not be the subject of relief against liability to tax for the year to which the return related. In that case, it was up to the Revenue, if it wished to achieve the contrary result, to make sure that the form of return did not permit such a claim to be made.

Section 9A(4) of the 1970 Act made it clear that the Revenue's enquiry might extend to “anything contained in the return, or required to be contained in the return”. The material words were “contained in”. Those words could not mean “required to be contained in” because that would make the alternative words redundant, contrary to well-established canons of construction. To be “contained in” a return, a matter had to be both actually contained in the return and be reasonably included in it in response to the particulars which the return sought.

In the instant case, the relevant boxes had permitted the taxpayer to make a loss relief claim if he chose to do so. It had also required him, if he did so, to give the information sought by the boxes, including the year in which he sought to take the relief. In the circumstances, the judge had been wrong on the jurisdiction issue. The Revenue should have followed the s 9A Procedure.

The taxpayer should have had a right of appeal to the First-tier Tribunal. Neither the county court nor the High Court had any jurisdiction to determine it.

Decision of David Richards J [2011] All ER (D) 212 (Apr) reversed. The appeal would be allowed.

Comments - This a test case, as several other people have made similar claims. The CA has specifically rejected HMRC's long-held view that a tax return for one year cannot include a claim for loss relief relating to a subsequent year. Unless HMRC appeals to the Supreme Court, the First-tier Tribunal will now have to adjudicate on the relevant claim for loss relief before HMRC can seek payment for the tax originally shown as due on the 2007/08 return.

MD Cotter v HMRC EWCA

Undue burden – Software to process is necessary

The appellant partnership intended to file a partnership tax return online by the 31 January 2011 deadline. However, when it went to make its online filing, it discovered HMRC did not provide the means for it to do so without it purchasing commercial software, so they hand delivered a paper tax return to HMRC's offices by the 31 January deadline, but later than the paper return deadline of 31 October. HMRC issued a £500 penalty for failing to file a paper return by the paper tax return deadline. The partnership appealed. The issue arose as to whether it was a “reasonable excuse” within TMA 1970 - which meant that an excuse was put forward and that when viewed objectively it was reasonable - for failing to file a tax return on time, that the authority requiring that tax return to be filed, had failed to provide a comprehensive online filing facility readily available for use by those required to file online.

Decision:

The partnership had established that it had an excuse for its failure to file online, which was that HMRC had failed to make available a suitable and comprehensive online filing facility for its use. Furthermore, it was reasonable—from an objective viewpoint—for the partnership to fail to file online in circumstances where HMRC failed to make such a facility available to it.

It was not remotely reasonable for HMRC to proceed in that way absent express authority from Parliament that it would and should do so. TMA 1970 s 12AA did not provide that HMRC could lawfully desist from providing a comprehensive online filing facility and/or providing that HMRC could require a partnership to search out and purchase software, if available, to allow a partnership to file online. Indeed, that further pre-supposed that any such person or partnership had the technical skill and knowledge to manipulate such software in such a way as to persuade it to allow online filing. It was not objectively reasonable for HMRC to impose that burden on a partnership, especially when it discriminated by providing a comprehensive online filing facility to individual taxpayers, but not to partnerships. HMRC did not explain why that was the case. Moreover, the statutory requirement for online filing did not carry with it an implied statutory obligation upon a partnership to equip itself with the means (both in terms of materials and skills) by which to make an online filing. Online filing relied overwhelmingly upon HMRC making the necessary technical or electronic wizardry available. It could not properly be said that Parliament had impliedly required a partnership to provide an unspecified part of that wizardry, leaving it to HMRC to provide only such part as they might choose to provide. Had Parliament intended to do so, it would have needed to do so in very plain terms. HMRC had simply chosen to impose a burden upon a certain categories of taxpayers, but not others. It followed that the appeal would be allowed

Comments – As would be potentially anticipated with Judge Geraint Jones acting as Tribunal judge he has found another rationale for a reasonable excuse in respect of levying of the penalties for the late submission of the relevant tax return. It is interesting to see after the restricted reasons that have applied over the years with regard to reasonable excuse for VAT that there are broader rationales being accepted in certain income tax return penalties.

St Georges Bricklayers (TC1636)

Partnership losing gross payment status - HMRC urged to reconsider the facts

The taxpayers, a father and son who worked in partnership in the construction industry, had to appoint a new accountant when their previous adviser retired. The taxpayers used to rely on their accountant to tell them when to pay their tax, but this was not the practice of the new one.

Both taxpayers made their interim self assessment tax payments in September, rather than by 31 July. As a result, HMRC withdrew the taxpayers' gross payment status.

The taxpayers appealed. As well as saying that they were used to being told when and what to pay by their accountant, the taxpayers had mislaid and misfiled documents and tax payslips, although when they found them, they forwarded the papers straight to the accountant and paid the tax.

HMRC claimed that neither taxpayer had reasonable excuse for the late payment of tax. The fact that withdrawing gross payment status would probably cause the partnership to go out of business was not a proper consideration, nor the fact that the in the past the taxpayers had always been compliant, as they also were since making the error.

Decision:

The First-tier Tribunal noted that gross payment status was withdrawn automatically by computer because of the late payment.

However, the judge referred the case back to HMRC for reconsideration, particularly with regard to the following:

- the partnership's unblemished compliance record;
- the fact that in his 60 years as a taxpayer, the father had never defaulted on his tax;
- lack of familiarity with their new accountant's way of dealing with clients; and
- the tax had not been withheld deliberately.

The taxpayers' appeal was allowed in so far as it was remitted to HMRC for reconsideration.

Comments – Again the Tribunal has exercised its prerogative to extend a more merciful approach than adopted by HMRC. However this case demonstrates the importance of the criteria which need to be adhered to to retain the gross payment status under the Construction Industry Tax Deduction Scheme. It is especially important in the current economy that gross payment status is not inadvertently jeopardised particularly as in this case where the taxpayers have previously had an unblemished compliance record.

BG and MA Saunders (TC1396)

Careless behaviour costs

The taxpayer submitted his 2008/09 tax return in September 2009, but did not include details of his employment benefits. HMRC opened an enquiry into the return and subsequently the taxpayer provided details of the benefits. He had made self assessment returns for the two previous years in which he had included details of benefits in kind.

HMRC imposed a penalty under FA 2007, Sch 24 para 1 on the basis that the taxpayer had been careless in completing his return. The taxpayer appealed, saying it was a simple mistake.

Decision:

The First-tier Tribunal gave a considered judgment, but concluded that the penalty was appropriate according to the regime. HMRC had assessed the correct penalty for careless error and reduced it to the extent that it could in light of the taxpayer's co-operation. The judge noted that it had been open to parliament when creating the penalty regime to have provided for a warning for the first error, but it chose not to.

The taxpayer's appeal was dismissed.

Comments – The tax return penalty regime levies penalties based on returns which are based on careless errors, deliberate errors and deliberate errors with concealment. Employees who are provided with benefits have to report them and in the case of someone who has previously reported them the omission of the benefits in a year after reporting for the two previous years this can be regarded as a classic illustrative example of careless behaviour.

David Collis (TC1431)

Real or test submission?

The company registered as an employer in March 2010. It believed that its 2009/10 P35 return had been filed online successfully in April 2010 and received an email acknowledging receipt. In September, the company received a late filing penalty of £400. The company's agent appealed and sent a copy of HMRC's successful receipt email. HMRC responded telling the agent that the email said the submission may have been a test. The agent said it was not 'good enough' for the Revenue to 'infer that a submission might have been a test'.

Decision:

The First-tier Tribunal said the burden of proof in a penalty case lay with HMRC (following *Jussila v Finland* (73053/01) ECtHR (Grand Chamber)). On that basis the judge decided that on the balance of probabilities, the return had been delivered to HMRC in time to meet the deadline, regardless of the fact that it was not stored as a live submission on the Revenue's computer.

The taxpayer's appeal was allowed.

Comments – It is essential for the integrity of the tax return submission process that taxpayers can rely on the software for electronic filing of tax returns. This is particularly true where there are different deadlines for filing using a paper return and an electronic return and penalties can result from the failure of one or the other. In this case there was evenly balanced evidence from HMRC and the agent regarding the test status of the submission and consequently the Tribunal veered towards the safe choice that of the onus of proof being placed on HMRC.

Global Legalisation Services Ltd (TC1430)

Visible record therefore delivered to HMRC

The taxpayer company believed it had filed its 2009/10 P11D(b) online before the 6 July deadline expired, and received acknowledgement from the department that it had been received. In November it received a penalty notice on the basis that the form had not been filed. The company director wrote back saying the form had been submitted in time, and enclosed a copy of the document. HMRC rejected the appeal saying the return was still outstanding. After speaking to HMRC, the company director resubmitted the form. It later emerged that the original return was visible on HMRC's system but was being blocked.

Decision:

The First-tier Tribunal noted that the legislation requires the P11D(b) to be delivered by a certain date, and that on the facts of the case, this had been done. If it was visible on the Revenue's system, it must have been delivered.

The company taxpayer's appeal was allowed.

Comments – Again it is essential for the integrity of a return form submission process that taxpayers can rely on the software for electronic filing. In this case it was another return with different penalties being relevant. HMRC in this case relied on their automated procedure of issuing penalties resulting in the taxpayer or agent having to spend valuable time proving that the return had been properly submitted and therefore the penalty was invalid. Two cases in the same month of tax returns failing to be recorded by HMRC in one way or another is not the best evidence of the integrity of the system.

Key Interiors Creative Associates Ltd (TC1434)

New Electricians Tax Safe Plan (ETSP)

Electricians around the country will start receiving letters in February from HMRC warning them to pay any undisclosed taxes.

The letter, going out to more than 50,000 electricians, explains that once the opportunity expires, HMRC will clamp down on those in the sector who have failed to declare earnings and pay the tax that they owe.

Under the Electricians Tax Safe Plan, electricians can come forward at any time between 14 February and 15 May 2012 to tell HMRC they want to take part. Once they come forward, they have until 14 August 2012 to make their disclosure and arrange for payment. If they make a full disclosure, most face a penalty rate of only 10 per cent, with a maximum of 20 per cent.

After 15 May, using information pulled together from different data sources, HMRC will investigate those who have failed to come forward. Substantial penalties or even criminal prosecution could follow.

How do electricians let HMRC know that they intend to make a tax disclosure?

- From 14 February, online by completing a form at: www.hmrc.gov.uk/campaigns/notify.htm
- Ring HMRC on 0845 601 5041 begin_of_the_skype_highlighting 0845 601 5041 end_of_the_skype_highlighting

If you take part in this campaign and tell HMRC about any income that you haven't previously disclosed:

- you may only have to pay for a maximum of six tax years.
- you can tell HMRC how much penalty you should pay
- you may be able to pay what you owe by instalments

HMRC Information, 14/02/2012

BUSINESS TAX

Small profits rate: inclusion of non-resident companies in computation

The appellant company (S) had traded as a Lloyd's insurance broker since 1971. Between the accounting years 2004 to 2007 S claimed marginal small companies' relief in respect of its corporation tax liability in accordance with TA 1988 s 13 (as amended by CTA 2010 s 19). HMRC opened an enquiry into those returns requesting information about S's group structure. S replied stating that it was the 100% subsidiary of a UK resident company (SH). SH's share capital was held by two Liberian companies, an investment holding company (G) (67%) and M (16%), and the remainder by two individual shareholders, A (10%) and AV (5%), who were also its directors. HMRC then requested further information about G. S replied that, as far as they were aware, G was a non-trading holding company resident in Liberia and they had no contact with that company other than to distribute dividends, but that information as to the ultimate ownership of G was not in its possession or power. Further correspondence followed trying to obtain further clarification.

In 2010 S supplied a letter from the President/Director of G confirming that G owned 57% of the shares in S, was not owned as to 49% or more by another company, and was not owned as to 49% or more by a person who also controlled another company. HMRC concluded that that was not sufficient information to settle the control issue, and control over S could be exercised by a person (whether an individual or a company) holding sufficient interest in both G and M. HMRC subsequently wrote to G requesting details of all the shareholders in the company, and a letter from each shareholder stating the shareholding in that company, and any other shareholding of five per cent or greater that they held in any other entity, and any shareholdings that were held by any connected parties that exceeded five per cent in any entity. No response was received.

HMRC disallowed S's claim for marginal small companies' relief and S appealed. The issue arose as to the extent of the evidence required to substantiate a claim to tax relief, here marginal small companies' relief. S contended that it was not necessary to prove beyond all reasonable doubt that there were no further associated companies; sufficient evidence had been provided to show that on the balance of probabilities there were no more. HMRC argued that the onus fell on the taxpayer, and that where there was an association with an entity based in a tax haven, such as Liberia, more evidence and a higher standard of certainty was required on the taxpayer's part than would be appropriate in the case of companies wholly within the UK.

Decision:

A taxpayer had to satisfy HMRC that on the balance of probabilities its claims for relief were correctly made. It was not necessary for the taxpayer company to prove that there were no associated companies other than those taken into account in the claims for marginal small companies' relief. Furthermore, in principle, the proof that a claim by a UK company indirectly owned by one or more non-UK companies met the conditions should not differ from the proof required in respect of a wholly UK-owned company. Any difference could raise issues of tax discrimination.

It was clear that in the event of an enquiry being commenced in the UK-based category of case, HMRC would be in a better position to require and obtain information as to all the companies to be taken into account. However, there were always theoretical possibilities of association, and information as to those was not as a matter of course required by HMRC in relation to UK-owned companies seeking the relief. It was possible to envisage circumstances in which an apparently wholly UK-based set of associated companies could, as a result of connections or associations between shareholders, be regarded as associated with non-UK resident companies. In the present case, there was no reason to treat S as being inherently less likely than a wholly-owned company to have made valid claims to the relief.

The information provided in correspondence, the long history of the business carried on by S, and its previous owners negated to a significant extent the implication in HMRC's argument that the Liberian companies had in some way sought to set up business in what they considered to be the most tax-efficient location. On the facts it was possible to discount the implication that some form of tax avoidance exercise had been involved. The documents G provided were of some value in establishing the facts relating to S's claim, even if they were not notarised statements. Although S was in a position to request confirmation of the details relating to G's shareholding and its associations, for a subsidiary within an international group structure there might be difficulty in going beyond a certain point in requesting information from an ultimate parent company as to possible “associations”. That company might be (or feel) entitled to set limits to the information provided, especially if it considered that the enquiry might be going beyond what it considered reasonable. S's efforts had been reasonable in relation to such elements of the enquiry that were, in turn, reasonably pursued. Once HMRC's enquiries moved into issues of association which appeared purely theoretical rather than having any apparent underlying factual justification, on the facts and evidence HMRC ceased to be reasonable in the context of S's claim to relief and therefore S was justified in not seeking further information from G. The decision whether the conditions for relief had been met depended on weighing the information realistically and practicably available. On the facts sufficient evidence had been provided by S to demonstrate that the possibility of the existence of any further associated companies beyond those covered by its claims could be discounted. Therefore the claims were correctly made and the appeal would be allowed.

Appeal allowed.

Comments - s24 CTA 2010 provides that a company's eligibility for the 'small profits rate' is affected by the number of associated companies which it has. Because the appellant company was ultimately owned in Liberia, HMRC took the view that it had not proved that it only had two associated companies. However, the Tribunal allowed the company's appeal, holding that it had provided sufficient evidence to show, on the balance of probabilities, that it had no more associated companies.

Seascope Insurance Services Ltd v HMRC (TC01664)

Group relief provisions: whether valid under EC law

The applicant UK resident companies were all members of a worldwide group of companies whose ultimate parent company was HWL, a company incorporated and resident in Hong Kong, between June 2002 to June 2005. In their corporation tax returns the applicants claimed consortium relief under TA 1988 ss 402 and 406 in respect of the substantial trading losses of one member of the group, the surrendering company, a company incorporated and resident in the UK.

The surrendering company was owned by a consortium of companies through an intermediate holding company: it was a 100% subsidiary of H, a UK incorporated and resident company which, on 7 November 2003, was owned by: I, a company incorporated and resident in Luxembourg; B, C and D, three indirect subsidiaries of HWL which were all incorporated and resident in the British Virgin Islands; and two other companies incorporated in the British Virgin Islands (BD – whose parent company was Japanese (DCM) and W – whose parent company was incorporated in the Netherlands (K)). I was a subsidiary of HE, a company incorporated and resident in Luxembourg, which in turn was owned by other Luxembourg companies. During each relevant accounting period the applicants were not less than indirect 75% owned subsidiaries of HWL, and they were neither directly nor indirectly owned by I.

In July 2000 K agreed to subscribe for shares representing 15% of H's issued share capital, and DCM purchased all the issued share capital of BD. On 7 November 2003 and on May 2004 HWL entered into share purchase agreements (the SPAs) agreeing to purchase from K all of the issued shares in W and all the issued shares in BD from DCM. On 23 June 2005 HWL exercised its rights under the SPAs. Since 23 June

2005 H had been 100% owned by HWL indirectly and directly owned by companies including I (50.1%), W (15%), and BD (20%).

Under TA 1988 s 406 in order for consortium relief to be available, there had to exist a “link company” which was both a member of the consortium and a member of the group of companies. The applicants claimed I was such a company as it was a member of the consortium owning, through H, the surrendering company and was in addition a member of the group of companies which included them. It was, however, common ground that the condition in TA 1988 s 402(3B)—that the link company was resident in the UK or carrying on a trade in the UK through a permanent establishment—was not satisfied in respect of I. HMRC opened enquiries into the applicants' returns. The following three questions were referred—as a joint referral by the applicants and HMRC pursuant to FA 1998 Sch 18, para 31A—to the tribunal for determination: (1) whether the requirement in TA 1988 s 406(2) infringed the EU law rights of any company in the group and if so, could the applicants rely on that infringement in support of their claims for group relief (“the EU law question”); (2) to what extent did art 26 (the non-discrimination article) of the Double Taxation Convention between the UK and Luxembourg (the DTC)—which had effect by virtue of TA 1988 s 788—impact on the applicants' claims for group relief (“the DTC question”). The applicants argued that the link residence requirements in TA s 406(2), (3A) and (3B) contravened art 26(4); and the effect of art 26(4), taken with TA 1988 s 788(3), was that they could obtain relief from corporation tax by means of the group relief claims notwithstanding the link company residence requirement; and (3) the impact, if any, of the anti-avoidance provisions in TA 1988 s 410. HMRC submitted the SPAs were “arrangements” for the purposes of TA 1988 s 410, which therefore precluded the claim for group relief.

Decision:

<u>On the EU law question</u>, the tribunal considered that it was necessary to refer the following two questions to the Court of Justice of the European Union: (1) In circumstances where (i) the provisions of a member state (such as the United Kingdom) provided for a company (a “claimant company”) to claim group relief for the losses of a company that was owned by a consortium (a “consortium company”) on the condition that a company that was a member of the same group of companies as the claimant company was also a member of the consortium (a “link company”), and (ii) the parent company of the group of companies (not itself being the claimant company, the consortium company or the link company) was not a national of the United Kingdom or any other member state, did arts 49 and 54 of TFEU preclude the requirement that the “link company” was either resident in the UK or carrying on a trade in the UK through a permanent establishment situated there? (2) If the answer to question 1 was yes, was the UK required to provide a remedy to the claimant company (for example, by allowing that company to claim relief for the losses of the consortium company) in circumstances where: (i) the “link company” had exercised its freedom of establishment but the consortium company and the claimant companies had not exercised any of the freedoms protected by EU law, (ii) the link(s) between the surrendering company and the claimant company consisted of companies not all of which were established in the EU/EEA.

<u>On the DTC question,</u> the tribunal considered that the inability of the surrendering company to make use of its losses by surrender in circumstances where its UK-owned counterpart could do so, and the inability therefore to obtain a payment for group relief, had the result that the surrendering company had been subjected in the UK to taxation that was other or more burdensome than the taxation to which corresponding enterprises were subjected. Although the inability to surrender losses could have no impact on the immediate tax liability of the surrendering company, and the fact that it carried forward the losses and might therefore suffer lower taxation in future accounting periods than if the losses had been surrendered, that inability, both to surrender and to obtain payment from the claimant companies for the losses, was a difference in treatment that fell within art 26(4) of the DTC. Furthermore, that difference in treatment was solely on the ground of non-UK ownership. TA 1988 s 402 discriminated against the surrendering company on the ground that its capital was in part indirectly owned or controlled by the Luxembourg company. Therefore, as the surrendering company was not permitted to surrender its losses in the way an equivalent UK-owned subsidiary could, nor consequently, receive a tax-free payment for group relief, the treaty obligation was to remove those differences in treatment. Thus, in order for the discrimination against the surrendering

company to be eliminated, art 26(4) required that the concomitant group relief had to be capable of being made. The effect of art 26(4) therefore was that the applicants had to be enabled to claim group relief in relation to losses surrendered by the surrendering company. On that basis the effect of the treaty obligation was not only to require that the surrendering company be entitled to surrender its losses notwithstanding the fact that its capital was partly, and indirectly, owned by I, but also required that the applicants be enabled to claim group relief on the surrenders of those losses. That requirement accordingly provided for relief from corporation tax, and so fell within TA 1988 s 788(3)(a) (subject to TA 1988 s 410).

On the TA 1988 s 410 question, the tribunal considered that, adopting a purposive approach to s 410, they could see no foundation for a construction outside of its clear words. The arrangements in question did not have to be shown to have an avoidance purpose. The definition of “third company” in sub-s (4) did not exclude a company that was a member of a consortium, or a member of the same group as a member of the consortium. It was quite clear that to import the exclusion from the definition of “third company” would open up the very opportunities for avoidance that Parliament was seeking to forestall. Section 410 did not operate in a subtle way; it was all or nothing. If the section did not apply, group or consortium relief was unrestricted, according to its terms. If it did, relief was wholly denied. There was no middle course that arguably might provide a more logical result in cases of that nature, where a claimant company was at one time a member of a consortium, and at another a member of a group. Therefore the effect of TA 1988 s 410 was to treat the surrendering company as not falling within s 402(3) for the period from 7 November 2003 to 22 June 2005 conclusive. Judgment accordingly.

Comments - The Tribunal referred the validity of the relevant UK group relief provisions to the CJEU. This case demonstrates a number of the key principles in group relief and consortium relief and becomes particularly important where you have a complex group structure and where companies are operating in different jurisdictions. The UK legislation has had a chequered history because of its design in a domestic context and this case shows this well.

Felixstowe Dock & Railway Co Ltd v HMRC (and related appeals) (TC01674)

Loan relationships: transfers within groups

A company (B), which was the parent company of a group, subscribed for zero coupon loan notes in a number of group companies. Those loan notes were then transferred to an associated company (V) for shares issued with a nominal value equal to the then value of the loan notes, but at a premium, on terms that the premium would be paid up by capitalising profits arising on the loan notes and appropriating those sums to V's share premium account. V claimed that the effect of FA 1996 s 84(2)(a) was that the credit that would otherwise be brought into account for corporation tax purposes on the accrual of profits on the loan notes under the 'loan relationships' rules did not fall to be brought into account. HMRC issued an amendment to V's return, increasing its taxable profit by bringing the disputed credit into account. V appealed.

Decision:

The First-tier Tribunal dismissed its appeal, applying the principles laid down by the House of Lords in Mawson v Barclays Mercantile Business Finance Ltd [2005] STC 1, and holding that 's 84(2)(a) does not have the effect of removing the accrued profits on the loan notes from tax'.

Comments - This was a test case for a UK-UK financing scheme. A great deal of money was involved. However, it is largely of historical interest, as the relevant legislation was subsequently repealed by FA 2004 Sch 10.

Vocalspruce Ltd v HMRC (TC01734)

Purchase of premises from subsidiary company

A company (B) agreed to purchase the freehold of a hospital from a subsidiary company (L) in 2001, paying part of the purchase price immediately and the remainder in three instalments from 2005 to 2007. In 2005 B and L modified the agreement and described £400,000 of the amount due from B to L as a 'premium'. B claimed a deduction for this amount in computing its profits. HMRC issued a closure notice rejecting the claim on the basis that the expenditure was capital.

Decision:

The First-tier Tribunal dismissed B's appeal against this decision. Judge Cornwell-Kelly observed that the terms of the agreement 'were evidently not typical of a bargain made at arms' length and were in fact devised with VAT avoidance in mind'. He held that 'on the face of it, any payment under a sale agreement must in the hands of the payer be presumed to be in the nature of capital, unless it is clearly otherwise'. The payment was a capital payment for the acquisition of a capital asset.

Comments - The Tribunal upheld HMRC's contention that the payment was capital expenditure, made for the acquisition of a capital asset.

Bluesparkle Ltd v HMRC (TC01743)

Capital allowances: UK finance company

A UK company (L), which carried on a trade of finance leasing, claimed capital allowances on expenditure on two ships, which were designed and built to ship liquefied natural gas from Norway to Spain and the USA. HMRC issued an amendment rejecting the claim, considering that the effect of CAA 2001 s 123(4) was that L was not entitled to the allowances it had claimed.

Decision:

The First-tier Tribunal allowed L's appeal, holding that the ships were used for a 'qualifying purpose' within CAA 2001 s 123(1). With regard to s 123(4), the Tribunal held that 'the question which has to be answered is whether a main object of the relevant transactions was the obtaining of those allowances, and this envisages that there may be a range of objectives motivating the transactions, and that they must be assessed in some sort of priority or hierarchy and then some basis applied to separate those which are of sufficient significance to count as “main” from those which are not. The issue is then which side of the line falls any objective of obtaining the allowances.' On the facts here, the restriction imposed by s 123(4) did not apply, so that L was entitled to allowances.

Comments - The Tribunal specifically rejected HMRC's interpretation of the restriction in CAA 2001 s 123(4), and held that the appellant company was entitled to the allowances which it had claimed.

Lloyds TSB Equipment Leasing (No 1) Ltd v HMRC (TC01745)

Capital allowances: expenditure on conversions

A company, which operated a large chain of public houses, incurred substantial expenditure in converting a dilapidated theatre, and two shops, into public houses. It claimed capital allowances on this expenditure. HMRC rejected much of the claim on the basis that various items of expenditure did not qualify as 'plant'. The company appealed. The Special Commissioners reviewed the evidence in detail and allowed the appeal in part, holding inter alia that decorative panelling did not qualify as plant because it was 'part of the premises'; that kitchen tiles also did not qualify as plant; that expenditure on a new drainage system qualified as plant, and that certain items of preliminary expenditure qualified for allowances under what is now CAA 2001 s 25. Following a further hearing by the First-tier Tribunal, both sides appealed to the Upper Tribunal, which dismissed the company's appeal and allowed HMRC's appeal in part, holding that expenditure on work in the toilet areas did not qualify for allowances.

Decision:

The tribunal also held that certain preliminary expenditure should be apportioned, observing that 'apportionment of preliminaries between items which do, or do not, qualify for capital allowances is the only solution in relation to unattributable preliminaries, and may be the sensible solution where attribution is uneconomic'.

Comments - The Upper Tribunal has partly allowed HMRC's appeal against the First-tier Tribunal decision. This is the latest in the history of this case – Wetherspoons have spent enormous sums of money over a number of years on the fitting out of their business establishments and consequently this is a very good example of a case testing exactly where the borderline in testing the expenditure is with sizeable sums related thereto. It is likely that this case will go further in the courts in view of the sizeable sums involved. Anyone reviewing clients' expenditure for capital allowances would be advised to examine the detail of this case.

JD Wetherspoon plc v HMRC (and cross-appeal) (UpperTribunal)

Tax issues arising on incorporation of a business **(Lecture B702 – 15.13 minutes)**

When a trade or business carried on by a sole trade, partnership or LLP is transferred to a company there are a number of tax issues that need to be considered. There are also some reliefs that may be relevant, dependent on how the incorporation is effected.

The transfer of chargeable assets to a company is a disposal for CGT purposes. Entrepreneurs' relief should be available if the qualifying conditions are met by the individual(s) disposing of the assets.

Incorporation using s 162 TCGA 1992

s 162 provides a form of roll over relief where all the assets of a trade or business are transferred into a company in exchange for an issue of shares by the company. It should be noted that this relief applies to businesses, which can include, for example, property rental businesses.

Using this relief, the company will acquire the assets at current market value, but the base cost of the shares will be the market value of the assets acquired, less the gains on the assets transferred into the company.

All the assets of the business must be transferred into the company in exchange for shares.

If the consideration incudes cash or other non-share consideration, a proportion of the gain (represented by the non-share consideration) will become chargeable on incorporation.

If the company takes over the liabilities of the business, this will not be treated as consideration under ESC D32.

Stamp duty land tax (SDLT) will be payable on any land or buildings transferred to the company.

Incorporation using s 165 TCGA 1992

Where a trade is transferred to a company it is possible to make a gift of chargeable assets, holding over the gain under s 165. However, the company will have a base cost equivalent to original cost for the assets, and the individual(s) will have no additional base cost of the shares beyond the shares subscribed for to form the company.

Other net assets of the trade will usually be transferred to the company by way of a credit to director's loan account.

This relief is only available for trades and for property used for the purposes of that trade. It is not available for property rental businesses, except for furnished holiday let businesses (which satisfy the requirements set out in s 325 ITTOIA 2005).

Notwithstanding that any land or buildings are transferred to the company by way of gift, SDLT will be payable on the market value of the assets.

Incorporation by way of sale to the company

If entrepreneurs' relief is available it is often appropriate to incorporate a business by selling the net assets to a company in exchange either for cash of by way of a credit to director's loan account. This means that the individual(s) pay CGT on chargeable assets at 10%, they can extract funds from the company with no further tax liabilities, and the company acquires the assets at current market value.

It is important to ensure that the assets, and in particular goodwill, are transferred to the company at market value. HMRC will look closely at the value attached to goodwill on incorporation and will seek to tax any overvalue either as a distribution or as remuneration from the company. HMRC will look at situations where the "goodwill" is personal to the proprietors, so that there is no separable goodwill that could be sold to a hypothetical purchaser.

SDLT will be payable on the value of any land or buildings transferred to the company. Stamp duty will not be payable on the transfer of goodwill. However, care should be exercised when the trade comprises land or buildings are integral to a trade, for example a restaurant or nursing home, as HMRC may seek to argue that "goodwill" forms part of the value of the property.

Other aspects to consider

When a trade is incorporated, the period of ownership of the shares for entrepreneurs' relief starts when the shares are acquired. There is no aggregation with the period of ownership of the unincorporated business.

The income tax position on cessation of the unincorporated business needs to be considered. Overlap relief or terminal loss relief may be available.

If losses are brought forward from previous periods, these cannot be transferred to the company, and in most situations they are lost. However, where a sole trader incorporates a trade using s 162, it may be possible to set those losses off against future income derived from the company.

The BPR position depends on how the incorporation takes place. The general rule is that assets need to be held for two years before BPR becomes available, although where the new assets have replaced the old assets the period of ownership can be aggregated. Using s 162 the shares issued by the company have replaced the business assets, so BPR would continue to be available as soon as the shares are issued. However, where the business is sold to the company for cash or by crediting a director's loan account, the two year period starts again on incorporation. Where s 165 is used the position is less clear cut, but it is usually possible to claim relief immediately on incorporation.

Contributed by Paul Howard

Venture capital reliefs **(Lecture B703 – 6.26 minutes)**

Following the £50,000 annual allowance cap which was imposed on pension contributions by FA 2011, more and more taxpayers are turning their attention to the merits of the venture capital reliefs, in particular the tax breaks associated with EIS and VCT investments, as an alternative means of boosting pension savings.

For many years, EIS investments have remained in the shadow of their better known and more widely used cousin, the VCT. However, this looks set to change.

VCTs have historically been seen as offering investors higher rates of income tax relief and simpler processes when it comes to making claims for relief. Some of the largest VCT providers are part of, or tied to, big fund management groups whose large marketing budgets may also have played a part in this outcome.

It can now be argued that the tax benefits enjoyed by investing in a qualifying EIS company or EIS fund are superior to those of VCTs. This situation arose out of George Osborne's last Budget when income tax relief on EIS shares issued on or after 6 April 2011 was increased from 20% to 30% – in other words, the Government are effectively funding almost one-third of any EIS investment. This establishes parity with VCTs on the income tax front, but the maximum annual amount on which an individual can claim EIS relief is £500,000 (rising to £1,000,000 on 6 April 2012). The equivalent limit for VCTs is still £200,000.

In addition, the EIS legislation provides investors with other advantages:

- IHT business property relief at 100%; and
- CGT exemption provided that the investment is held for at least three years (although gains on qualifying VCT shares are also tax-free).

Furthermore, EIS investors have a shorter minimum holding period than VCTs in order to qualify for their tax reliefs (three years as opposed to five) and it is only the EIS regime which allows an indefinite CGT deferral on gains made in the previous three years.

One point in favour of VCTs is that their dividends are completely free from income tax, whereas dividends from an EIS investment are taxable in the normal way – this may make VCTs preferable for income-seeking investors.

In summary, therefore, both schemes are worth investigating for higher and additional rate taxpayers. As one commentator has remarked:

'They are not some arcane and esoteric tax wheeze dreamt up by a clever accountant and therefore open to challenge from HMRC. It was Ministers who created them. And the Coalition intend to make them even more attractive to many more investors.

This is because the Government see them as powerful tools to fire up stalling UK economic growth. They view enterprising smaller companies as key in replacing lost public sector jobs and are committed to encouraging investment in them.'

Contributed by Robert Jamieson

Company dissolutions and ESC C16 **(Lecture B704 – 13.16 minutes)**

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

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

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

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

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

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

On 14 October 2011, the £4,000 limit was suddenly withdrawn by the Treasury Solicitor. In other words, if any share capital was repaid to shareholders under a dissolution, it could potentially be recovered as bona vacantia. However, just as abruptly, the Treasury Solicitor's office subsequently retracted this notice and replaced it with a new one which categorically stated that, under no circumstances, would they seek to confiscate any share capital paid out prior to a dissolution, ie. regardless of whether the amount was above or below the old limit. This climb-down was well received. For example, the Tax Faculty said:

'In our view, this is a very welcome clarification which demonstrates the intention of the Treasury Solicitor to reduce the administrative burden on companies as far as possible. The legal position remains that share capital must be formally reduced and then formally distributed before it can be paid out (in order) to avoid any assets in the company on dissolution being lawfully due to the Crown. The revised Treasury Solicitor's guidance now makes it clear, however, that, even where the legal formalities are not undertaken to reduce the share capital prior to dissolution, it will not seek to recover any amounts. The reason is probably that, for any significant amount, the company could be reinstated and the necessary formalities undertaken (so that there would be) no net gain to the public finances.

So reason has prevailed. Companies can be dissolved using ESC C16 as before without worrying about the amount of share capital that is also being paid back to shareholders.'

Draft legislation to give legal effect to ESC C16 has recently been introduced in the form of The Enactment Of Extra-Statutory Concessions Order 2012, which, in this context, comes into force for distributions made on or after 1 March 2012. However, it is important to note that the enacting legislation narrows the category of distributions which are to be treated as equivalent to distributions following a formal winding up by imposing a monetary limit of £25,000 on all amounts returned to shareholders (ie. not just share capital).

The rationale for this modest limit is stated to be for 'anti-avoidance reasons'. CGT treatment will only be in point if the total distributions do not exceed £25,000. If the dissolution distributions are greater than £25,000, income tax is payable on the whole amount.

One problem which has been identified by the CIOT and the Tax Faculty is that, where the dissolution process starts before 1 March 2012 and the distributions straddle that date, the pre-1 March 2012 distributions have to be counted along with any post-29 February 2012 distributions in order to determine whether the £25,000 cap has been breached. In other words, even where an ESC C16 application has been accepted by HMRC in respect of distributions made before 1 March 2012 and a distribution of £25,000 or less is made on or after 1 March 2012, the transaction will not be eligible for CGT treatment if the accumulated payments made in anticipation of the striking off exceed £25,000. This is the clearly stated view of HMRC with whom the CIOT and the Tax Faculty are currently in discussion. Companies in this position may therefore wish to consider the timing of their distributions.

If this situation is not resolved in the company's favour, there will be similar difficulties in future years where distributions straddle the start of a new tax year.

Contributed by Robert Jamieson

VAT

No retrospection permitted

The taxpayer owned a dress agency business. She took over the business as a going concern in October 2006 and continued to complete quarterly VAT returns. In November 2010, she applied to deregister on the basis of reduced turnover. She requested that the deregistration be backdated to September 2010 and explained that she could have applied to deregister in 2008.

HMRC said that her deregistration could not be retrospective and that it would have effect from November 2010. The taxpayer appealed.

Decision:

The First-tier Tribunal sympathised with the taxpayer, agreeing that she could have deregistered for VAT two years before. However, the law was clear: HMRC have no power to make retrospective deregistration.

The taxpayer's appeal was dismissed.

Comments - The decision shows the importance for advisers to monitor closely a business's sales, said Neil Warren, independent VAT consultant. 'If taxable sales in the next 12 months are expected to be less than £71,000, a taxpayer can apply to deregister on form VAT7. There is no scope in the legislation for the date to be backdated before the date of application.'

Ilkley Dress Agency (TC1535)

Too trusting

The taxpayer was employed by her father full time on a PAYE basis in his kitchen business, Maelstrom. In late 2006, Mr Bradbury, a customer of the business, moved to Spain and set up a kitchen business, buying his cupboard carcases from Maelstrom. In December 2006 the taxpayer's father and Mr Bradbury decided the taxpayer should go into business on her own, and then Mr Bradbury would submit his orders to her. She would process the order, obtain the necessary goods from Maelstrom and supply them to Mr Bradbury.

The taxpayer's business ceased trading in August 2008 and it transpired that she had used an invalid VAT number on her invoices. Subsequently, Mr Bradbury's business was closed down, leaving the taxpayer with unpaid invoices totalling almost £38,000. She believed she was a victim of a deliberate fraud by Mr Bradbury. She and her father had contacted HMRC to obtain advice on how to deal with the exports to Mr Bradbury and had been referred to public notice 725, section 4.3.

HMRC subsequently raised an assessment on the taxpayer on the basis that she had incorrectly zero rated supplies to Mr Bradbury in Spain and also issued a misdeclaration penalty.

The taxpayer appealed.

Decision:

The First-tier Tribunal said it was common ground that the taxpayer used an invalid VAT number for the supplies she was making, and that these should have been standard rated. The question was whether she should have to account for the tax. According to notice 725, section 4.10, if she had taken reasonable steps to ensure the validity of the number, she would not have to pay the VAT. However, the tribunal concluded that she had not taken any such steps. Instead she had chosen to rely on what Mr Bradbury told her, a customer who had had past trading problems with her father. This should have alerted her to the likelihood that he was not reliable. She was therefore liable for the tax as assessed.

With regard to the misdeclaration penalty, the tribunal said it was appropriate, but that HMRC should mitigate it by 50% to take account of the taxpayer's co-operation.

The taxpayer's appeal against the assessment was dismissed, but the appeal against the penalty was allowed in part.

Comments - The taxpayer should have been more cautious, said Neil Warren, independent VAT consultant, because the customer (Mr Bradbury) already owed £10,000 to a separate business owned by her father, a debt that had been written off. So there were previous problems that the tribunal felt should have persuaded the taxpayer to adopt a more cautious approach in her dealings with him. Mr Warren added that the conditions for zero rating the sale of goods to an EU customer 'are clearly explained in HMRC's VAT Notice 725, section 4.3. The conditions have the force of law and are clearly marked to that effect in the notice as a warning point'. Furthermore, he said 'it is important that a customer provides the VAT number that has been allocated to his business for the purposes of intra-EU trade, rather than an internal tax or fiscal number that is only relevant in his own country'.

It is possible to check the validity of a customer's VAT registration number on the Europa website, see www.lexisurl.com/euch.

J L Eydmann (TC1569)

Best judgment is acceptable

Tufail traded as a grocer from three premises. As it sold a variety of items the business was entitled to account for VAT by using any of the retail schemes described in VAT public notices 727 and associated numbers, or under any other retail scheme if it was prearranged and approved by HMRC. The method it used was based on ascertaining the costs of zero-rated items purchased, estimating their mark up, and then taking account of theft, wastage and any similar adjustments. This adjusted figure was then deducted from the total sales, leaving a total for standard-rated sales.

After a visit to the business, HMRC decided that the methodology used to calculate Tufail's VAT liability was invalid. They conducted a mark-up exercise based on the expected selling prices of the most popular standard-rated items sold in the shops and, as a result, concluded that VAT had been underdeclared. They calculated that further VAT amounting to £15,515 was due on the basis of using their best judgment. They said, in addition, that the business had not used any of the recognised retail schemes properly and would have to use a different one.

The taxpayer appealed, claiming that two of the three shops were located in areas where there were many drug users, and therefore shoplifting was a problem and a contributory factor for the low output tax payments on VAT returns.

Decision:

The First-tier Tribunal accepted HMRC's figures and noted that the taxpayer provided no evidence as to how the business dealt with the calculation of VAT or complied with any of the accepted retail schemes. The Revenue had used the information available to it and used best judgment in making the assessment.

The taxpayer's appeal was dismissed.

Comments - The challenge for advisers, when HMRC carry out a mark-up assessment, is to ensure that all reasonable allowances have been taken into account where the full selling price is not achieved on goods, said Neil Warren, independent VAT consultant. He suggested that reasons might be down to pilfering, bulk sales or trade discounts, damaged or out-of-date stock not being sold, etc. He added that 'it is also important to confirm that the representative period used for the mark-up calculations is truly representative'.

Tufail, Din, Akbar and Tufail (TC1565)

Register in advance

The taxpayer was an accountant who began in business in November 2010. As an accounting service provider, she was required to register under the money laundering regulations, but assumed there would be a period of grace before she had to register. She submitted her registration to HMRC in March 2011. The department imposed a penalty for late registration on the basis that she should have registered before she began providing accounting services.

The taxpayer appealed. She said it was impossible to tell from HMRC's website when registration was required and that the website should be made much clearer on the matter.

Decision:

The First-tier Tribunal said that 'in principle, ignorance of the law is no excuse'. Even if the appellant had no idea that she was supposed to register, it would not be a reason to set aside the penalty. However, the tribunal noted that the appellant knew she had to register, so she should have taken 'all reasonable steps and all due diligence' to ascertain the deadline. The tribunal accepted that the appellant did not find HMRC's website user-friendly, but said she could have obtained information by other means. There was no reason to quash the penalty.

The taxpayer's appeal was dismissed.

Comments – The well worn principle of ignorance of the law is no excuse is always relevant in situations like this but with an accountant offering accounting services it would be likely to be successful. It is apparent from even a cursory glance of the HMRC website the circumstances in which a trader is required to register as it is included on the first page – Introduction to VAT.

Renaissance Accountancy Services Ltd (TC1779)

VAT partial exemption developments **(Lecture B705 – 17.14 minutes)**

This article examines four recent cases on aspects of partial exemption:

- two in which traders succeeded in persuading the courts or tribunals that their proposed special method of partial exemption was fair and HMRC acted unreasonably in refusing to agree to it;
- one in which the capital goods scheme might have caught a trader out, but an unlikely escape route was found on appeal;
- one in which a trader asked for a review of a decision to disallow some input tax, and regretted it because the reviewer disallowed more – this time the appeal was unsuccessful.

The notes below also report the issue of an updated notice on the Capital Goods Scheme, which was significantly changed for expenditure incurred from 1 January 2011 onwards.

House wins again on PESM in Court of Appeal

A company engaged in the casino, restaurant, bar and entertainment business proposed a floor-area based special method for partial exemption. HMRC rejected it and the company appealed to the Tribunal.

The First Tier Tribunal examined the way in which the business was organised at the several different locations operated by the company. It noted that a significant amount of food (taxable) was in fact given away to gamblers. In addition, significant areas of the properties were not used to make any supplies, but were communal areas, passageways, reception etc. Some 71% of residual input tax was argued to be property-related, which the company contended made the use of floor areas a reasonable proxy for "use" of inputs.

The proposed special method took the floor areas that were used to make supplies and ignored the rest. It was proposed that residual input tax should be recovered using a calculation as follows:

- the "T" part would include the whole of the area given over to taxable gaming and entertainments, but only a proportion of the areas of bars and restaurants – that would be reduced to reflect the proportion of food and drink that was given away free;
- the "E" part would include the remainder of the bar and catering areas and the exempt gaming areas as well.

HMRC used their normal arguments against floor-based methods, citing the Tribunal's decision in Vision Express in support. They also argued that treating all the residual input tax as property-related was not likely to produce a fair result.

The First Tier Tribunal disagreed. The situation was quite different from that in the opticians' cases. Allowance had been made for the cross-subsidisation of food and gaming by removing the "free food and drink" from the "T" part of the calculation. The case was different from that of Aspinalls, in which most of the food and drink was given away; here, the catering was a genuine business activity which made a significant contribution to overheads. Overall, the Tribunal was satisfied that the proposed method would produce a fair result.

It was then necessary to consider whether it gave a fairer result than the existing special method (which dated from 1993). That was turnover-based, and the company's counsel had several criticisms of it. The two significant ones were that:

- it was wrong to use turnover as a proxy for use in this case because there were more costs incurred in earning £1 of catering income than there were in earning £1 of gaming income;
- a turnover-based method would produce unpredictably fluctuating results depending on how lucky the customers were, and this was clearly unfair and unreasonable when the costs did not vary at all.

The First Tier Tribunal accepted these arguments and allowed the appeal. The proposed method was fair and reasonable, and more so than the existing method.

HMRC appealed to the Upper Tribunal, which upheld the decision as a reasonable one on the basis of the evidence. The judge started by commenting on the principle that the appellate court should not normally interfere with a finding of fact, but he still examined the decision in detail and agreed with its reasoning at each level.

HMRC tried again in the Court of Appeal, arguing that the Upper Tribunal had come to an unreasonable decision and had failed to follow the correct approach. The Court dismissed this argument, holding that the Tribunal had understood and applied the law correctly. There was a finding of fact that the catering activity, while not profitable at present, was nevertheless a business in its own right, independent of the gaming activity. That finding could not be disturbed and was justification for the decision that the PESM was fair and reasonable.

Court of Appeal: London Clubs Management Ltd v HMRC

Special method approved

There has been a long-running dispute between the leasing industry and HMRC about the proper attribution of overhead input tax. In R&C Brief 31/2007, they declared a new policy to be applied from 1 April 2007 onwards: HP finance was to be treated as a wholly exempt activity, even if legally there was a taxable supply of goods, and as a result the overhead input tax incurred by an HP financier was to be regarded as wholly attributable to making exempt supplies. The logic behind this approach was explained as follows:

"In most HP transactions, the goods are resold at cost without any margin to cover overhead costs. As there is no margin on the HP goods, the cost of the overheads will normally be built into the price of the supply of credit. In this scenario, HMRC's view is that the overheads are purely cost components of the exempt supply. Otherwise the business would continually enjoy net VAT refunds despite:

- making no zero-rated or reduced rate supplies; and
- charging a total consideration under the HP agreement that fully recovers its costs and an element of profit."

This Brief was later reissued as RCB 82/2009.

VW Financial Services agreed a partial exemption special method with Customs in August 2000. It was based on a 1984 agreement between the Finance Leasing Association and Customs that restricted recoverable overhead input tax in a finance business to 15%. However, the FLA withdrew from the 1984 agreement during 2000. In 2007, VWFS returned to HMRC with a suggestion for a new PESM. By this time, the new policy was in operation, and the company's proposal could not be agreed – they suggested that the overhead input tax in relation to retail business should be determined by the proportion which taxable transactions bore to total transactions. This transaction count was based on every HP agreement being two transactions (one taxable, one exempt), every leasing transaction being two transactions (both taxable) and every fixed price service and maintenance contract as one (taxable) transaction. On this basis, 50% of the residual input tax referable to HP transactions was recoverable.

For the four periods 10/07 to 07/08, the company applied its preferred PESM and received assessments against which it appealed. After that it operated HMRC's preferred method and made voluntary disclosures to claim more input tax, and appealed against HMRC's refusal to pay these. The total amount in issue before the Tribunal was about £500,000.

The Tribunal examined the organisation of VWFS into eight departments and the way it did business. It also went through the PESM in detail. The company's approach was to apportion overhead input tax between the number of taxable and exempt transactions (i.e. payments received, rather than contracts entered into) in each period, without regard to their value. HMRC divided the input tax between the different classes of business, but then used a value-based apportionment in which no account was taken of the initial value of the taxable car. A small amount was still recoverable under HMRC's method because there were other taxable supplies such as settlement charges and option to purchase fees.

The Tribunal considered a number of precedents on the basis for deducting input tax on overheads, including BLP Group plc, Abbey National plc, Midland Bank plc, Kretztechnik, Cibo Participations and AB SKF. The Tribunal came to the conclusion that HMRC's approach was not logical: to attribute overheads entirely to the exempt part of a mixed transaction was inherently unfair and unreasonable. It was not necessary for the input tax to be passed on to the consumer in the form of a directly identifiable element of the price charged. The input tax was incurred in relation to both taxable and exempt transactions, and VWFS's approach was a reasonable one.

Presumably this will make HMRC look again at their policy on HP finance. They will have to decide whether to accept defeat, or to appeal and defend RCB 82/09 in the Upper Tribunal.

First Tier Tribunal (TC01401): Volkswagen Financial Services (UK) Ltd

Capital goods scheme considered

A company (T) appeared to achieve a fortunate result in a dispute about the operation of the capital goods scheme. It had purchased four aircraft hangars in June 2004, paying VAT of £332,500 (which was charged at the last minute by the vendors – it appears that the directors did not fully understand the consequences). The hangars were used by the company itself and by associated companies. In October 2006 T transferred the property to an associated company and treated the supply as exempt. HMRC raised an assessment to claw back input tax of £232,750 under the CGS.

The company appealed, arguing that this was the wrong assessment. In fact, it should not have claimed this input tax back to start with, as its intention was always to put the buildings partly to exempt use. This should have been taken into account in the year of acquisition using the standard method override, leaving the initial recovery "correct" and avoiding the need to make any further CGS adjustments. It was too late to make such an amendment by the time HMRC raised the issue in 2008, and clearly much too late in 2011.

The Tribunal accepted these contentions. There had been no change of intention and therefore nothing that ought to trigger the CGS. Although this may seem a surprisingly favourable decision, the company's accountants pointed out at an early stage that there was no reason for the company to suffer "sticking VAT" – all its trading activities were taxable, and it could have avoided any exempt activity by forming a VAT group or opting to tax. These are things that cannot be done after the event to correct an error, so the alternative "wrong assessment" argument has worked instead to achieve "the right result".

First Tier Tribunal (TC01543): Turbine Motor Works Ltd

Farmhouse sale

A farmer sold her farm after the cessation of trade, incurring £11,122 of professional fees, which she claimed as input tax on her return. After a visit, an officer stated an intention to assess £8,100 of this as residual input tax which was apportioned to exempt supplies. The farmer accepted the offer of a review, which resulted in the assessment being increased to cover all the input tax claimed.

The taxpayer's representative argued that there was a sufficient link between the sale of the farm and the past taxable supplies by the farm to make the input tax residual. The Tribunal did not agree: there was a clear and immediate link between the expenses and an exempt supply, and the authority of cases such as Midland Bank and BLP Group required the input tax to be attributed in that way. The appeal was dismissed.

First Tier Tribunal (TC01519): Mrs L A Parkhouse

Updated Notice

HMRC have issued an updated version of the notice on the Capital Goods Scheme, replacing the January 2002 edition. Although it does not list the amendments, it reflects the major rewriting of the law which took effect from 1 January 2011. It also covers the transitional rules which will continue to apply to CGS assets purchased before 1 January 2011 until the end of their adjustment period.

Notice 706/2

Contributed by Mike Thexton