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STOP PRESS

Plans to cap charitable tax relief have now been scrapped by the government.

On 31 May 2012 Mr Osborne said "I can confirm that we will proceed next year with a cap on income tax reliefs for wealthy people, but we won't be capping relief for giving money to charity."

PERSONAL TAX

Tax relief on loans for interests in close companies (Lecture P716 – 6.40 minutes)

This well-known type of qualifying loan has specific requirements to be met under Ss 392 to 395 ITA2007:

- The loan must be to enable the borrower to (a) buy shares in a close company, other than via the Enterprise Investment Scheme, or Seed EIS, or under a CGT reinvestment relief claim; or (b) to provide funds to lend to the company.
- The company must not be a close-investment holding company (CIHC). It must also not be in the business of occupying commercial woodlands.
- The individual must meet the *capital recovery condition* and either (a) the *full-time working conditions* or (b) the *material interest conditions*.
- If the funds borrowed are lent on to the company they must be used wholly and exclusively for the purposes of the business of the company, or of an associated company provided the latter is also a close company but not a CIHC.

The *capital recovery condition* is that in the period from use of the loan to payment of the interest, the individual has not recovered capital from the company. Under Section 406(2) ITA2007 any amount recovered is treated as reducing the loan for this purpose.

The *full-time working conditions* mean that the individual must own some of the ordinary share capital, with no minimum requirement, and spend the greater part of his time on the actual management or conduct of the company or an associated company. The time test is from the date when the loan was used up to the payment of the interest claimed as tax deductible.

The *material interest conditions* are that the individual (alone or with any one or more associates) is either (a) the beneficial owner of or able to control over 5% of the ordinary share capital, or (b) entitled to acquire such rights as in the event of a winding up would give entitlement to over 5% of the assets available for distribution to *participators*. If the company exists wholly or mainly to hold investments or other property, without it being a CIHC, the condition (b) must be met, or no property held by the company may be used as a residence by the individual.

Participators for this purpose is defined in Section 454 CTA2010, and includes:

- Those entitled to acquire share capital
- Those entitled to acquire voting rights
- Loan creditors

The above tests seem well-established, but were the subject of an interesting case in *A Nowosielski v HMRC TC01907* as under:

1. Mr N agreed to lend £100,000 to V Ltd of which he was a director but not a shareholder.
2. He financed the loan by increasing the mortgage on his home.

3. HMRC rejected the claim for tax relief on the loan interest on the grounds that Mr N did not have a material interest in V Ltd as he was not a shareholder.

4. Mr N had a 50% interest in P Ltd which was an associated company of V Ltd which in turn had a controlling director who was a major shareholder in P Ltd.

5. Mr N was therefore a participator in V Ltd and entitled to far more than 5% of the assets on a winding up. He was therefore entitled to tax relief on the loan interest.

Contributed by Gerry Hart

P11Ds – Some key tips

As we are into the P11Ds season it is worth bearing in mind a number of issues to get the matters rights and reduce the likelihood of penalties for mistakes. Completing P11Ds covers many areas of employment income and benefits – in fact more than sufficient for a three hour lecture. This note highlights some areas of current relevance.

Starting with the issues of whether the reporting needs to be done in the first place

<u>Dispensations</u>

Dispensations provide a very useful reduction in the reporting of benefits and expenses. It is worth remembering that they need to be checked to ensure that they remain valid and provide the protection that they are designed to achieve. The guidance regarding how much effort employers are asked to put into checking dispensations once granted has been amended and is of sufficient importance to make it worthwhile repeating in full - EIM30059 - dispensations: checking and authorisation of expenses payments.

After a dispensation has been granted, the extent of checking undertaken by the employer will depend upon the scale of the business. They will need to demonstrate that someone other than the employee incurring the expense is responsible for ensuring that the claim made by the employee:

- Relates to qualifying travel in the case of travel and subsistence expenses
- Does not include disallowable items. The rules in S336-9 ITEPA 2003 (see EIM31600 onwards and EIM31800 onwards) will apply, and
- Is not excessive.

<u>Cars</u>

These are always a key item to be dealt with on the form P11Ds. Recent cases (a surprisingly frequent occurrence) have demonstrated that a number of avenues are being used to avoid the car benefit charge including advocating the car is a pool car and the use of the car is by virtue of joint ownership rather than the provision of the car by reason of employment. Pool cars have to meet stringent conditions (all of them not just selected conditions) and these will be checked.

Watching out for the validity of an explanation of why the car does not deserve a benefit is not the main task but getting the basics right. You need to be aware in the constantly changing parameters for company cars – each year recently and for years to 2015/16 have changes announced well in advance.

Those relevant to the 2011/12 P11D are:

- 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

As always there are changes to the various thresholds both with "normal" vehicles and lower emissions vehicles – remember to keep them in mind. And don't forget the rules for vans!
In the current environment with the expensive cost of fuel what arrangements exist for covering the cost of fuel? Does the employer reimburse the cost of fuel used in the employee's car? Don't forget the fuel advisory rates changed four times! (1 June 2011, 1 September 2011, 1 December 2011 and 1 March 2012) in 2011/12 as fuel prices increased inexorably – currently fuel prices appear to be stabilising (downwards) and so we are likely to see the rates changing again.

Childcare
Special care may need to be paid to childcare arrangements in light of the changes which happened in April 2011 creating a two part system: arrangements that applied to those individuals in arrangements before 6 April 2011 and those entering arrangements after April 2011.

You may need to report excess childcare vouchers or payments on the P11D. The rules affect employers operating two types of scheme:

- Childcare vouchers
- Directly contracted childcare

Workplace nurseries continue to be a tax free benefit without limit provided conditions are met.

When an employee joins a scheme on or after 6 April 2011 the employer must carry out a calculation to establish the "relevant earnings amount". 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 relevant earnings amount is compared with the higher and additional rate thresholds of £35,000 and £150,000. The computation, however, allows for the deduction of the standard personal allowance from the total income plus expenses which would be deductible for tax. See EIM16056 for more details.

The end of the year means the employer needs to ensure that the rules were operated correctly for the year just finished (2011/12) – and whether any excess payments need to be reported – and also looking forward to 2012/13 for whoever it may be relevant. What to do with excess payments:

- 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

Mobile telephones

A single mobile phone provided by the company on which an employee can make private calls is tax free. If the phone is in the name of the employee this exemption does not apply, and the amounts paid must be apportioned between business and private use, remembering that the basic airtime charge will always be private if the phone is in the name of the employee.

The employee will be taxable on the full cost of the provision of the phone, which may include a benefit for the handset cost at 20% of the cost. The bills paid on a taxable phone will give rise to a benefit, but some apportionment of the bill may be possible for business calls, when billed in excess of the line rental charges.

When considering the reporting of mobile phones don't forget the correct treatment may need to be considered with any employer provision or contribution to phones at the employee's home address.

HMRC has recently announced that the provision of a Smartphone – such as a BlackBerry or iPhone is now regarded as the provision of a mobile phone and is to be taxed as such from 2011/12. If you have reported benefits in kind in respect of a single smartphone provided by an employer then the Class 1A NIC can be recovered back as far as 2007/08. You will need to follow the process in Revenue & Customs Brief 02/12.

Care is needed where there is provision of or payment in respect of the landline at the employee's home?

Internet access

Where an employer provides for Internet access (on a company contract) at the employee's home solely for work purposes, under a package where there is no separate billing or record of access calls, and no breakdown is possible between work and private calls, where private use is not significant (and private use does not affect the cost of the package) the costs of connection are exempt from tax under Section 316.

For tax purposes the cost of providing the telephone line to connect to the Internet is a separate matter from the contract between the ISP and the employer or employee. The treatment of the telephone line rental and call charges depends on who has contracted with the provider of the telephone line.

Where an employee is the subscriber for Internet access to his or her home, and the employer reimburses the employee for these costs, there is no scope for the exemption in Section 316 to apply, as the employer is not providing a benefit. Reimbursements are taxable as expenses payments. If the employee can show that some or all of the Internet costs related to use wholly, exclusively and necessarily in the performance of his duties, he may be entitled to a deduction under Section 336 ITEPA 2003.

Where an Internet package, such as for Broadband access, provides unlimited access and no separate billing procedures to separate business use from private use, it is not possible for an employee to identify the business part of the cost. Consequently the position for these packages is the same as for similar mobile phone packages. If there is no identifiable cost that is wholly and exclusively for business use, no deduction will be due.

There is guidance for employers about reimbursing internet access charges under the homeworking rules in Section 316A. This makes it clear that the payment of broadband bills for employees will only be regarded as additional costs incurred because of homeworking when the employee was not already paying for internet connection, or when the broadband speed had to be upgraded at additional cost because the employee was working from home. Only the additional costs incurred can be exempt under Section 316A. (EIM01475).

As always care needs to be exercised with all aspects of P11Ds as it is a form that is it is notoriously easy to make mistakes on and the penalties are significant thereon.

Contributed by Tony Jenkins

Cap on unlimited income tax reliefs **(Lecture P717 – 6.09 minutes)**

While the feared basic rate restriction for pension contributions did not materialise in the Budget, the so-called 'tycoon tax' has emerged in the form of a ceiling on the ability of wealthy individuals to claim certain income tax deductions. This is a completely new concept for UK taxation.

With effect from 6 April 2013, taxpayers seeking to obtain more than £50,000 of otherwise unlimited income tax reliefs in any one year will find their deductions capped at the greater of:

- 25% of their total income; or
- £50,000.

This will not affect claims for EIS or VCT reliefs and pension contributions (all of which have an upper limit), but it will apply to sideways relief for ordinary trading losses, share loss relief under S131 ITA 2007 and allowable interest.

Charitable donations

The plan had been to include Gift Aid donations and gifts to charities of quoted shares and land. However, on 31 May 2012 the government announced that there would be no restrictions on income tax relief when donating to charities. Mr Osborne said "I can confirm that we will proceed next year with a cap on income tax reliefs for wealthy people, but we won't be capping relief for giving money to charity."

Impact

The impact of this proposal has been summarised by one commentator as follows:

'The objective to ensure that in any year taxpayers with very high incomes make significant tax contributions is difficult to argue against and is in accord with practice in certain other countries, eg. the USA. We would hope that the Government would introduce rules to allow the carry-forward of unused relief so that individuals …..investing in business are not discouraged.'

Loss relief

The stated intention of the proposed limit is that capped reliefs will not be caught. Given that certain sideways loss reliefs, eg. for inactive partners, are already capped, this could, in some circumstances, lead to the position where active partners are able to claim less tax relief than those who are not so involved in the business. This cannot have been intended. Fortunately, there is to be a consultation period before draft legislation is produced and it is hoped that, in addition to ensuring that charities and their philanthropic donors are not too badly affected, the Government will clarify the extent to which business losses are to be restricted.

Contributed by Robert Jamieson

Who pays the tax when the scheme fails – the company or the employee?

Aberdeen Asset Management entered into a tax avoidance scheme involving payments into an employee benefit trust to pay bonuses to certain employees.

The First-tier Tribunal held that the scheme failed. Aberdeen AM accepted that decision but the issue remained as to who was liable to pay the outstanding tax on the awards made to the employees. The company agreed that it was responsible for the National Insurance but argued that the tax should be collected from the employees. HMRC said the company should pay it.

Decision:

The Upper Tribunal (Tax and Chancery Chamber) said that the purpose of the scheme was to pay a bonus to the employee. Rather than paying cash, the scheme provided the employee with the rights of a shareholder possessing all the shares in a cash-rich debt-free company.

Viewed realistically, the employee controlled the company and he could, in practice, take money out of the company whenever he wanted to. The shares in the company were a readily convertible asset and Aberdeen AM effectively made a payment of income of that amount. It was therefore liable to account for tax on those sums.

The taxpayer company's appeal was dismissed.

Comments – Normally when we see a particular "scheme" fail at the hurdle of one or other of the levels of the Court system we do not later see the company try to "wriggle" out of the liability to tax. In this case the Tribunal correctly determined that the tax liability remained that of the company.

Aberdeen Asset Management plc v CRC, Upper Tribunal

Social Security - Child Tax Credits rules – Discrimination?

Regulation 3 of the Child Tax Credit Regulations 2002, SI 2002/2007, so far as material, provides: "(1) For the purposes of child tax credit the circumstances in which a person is or is not responsible for a child or qualifying young person shall be determined in accordance with the following Rules. Rule 1·1 A person shall be treated as responsible for a child or qualifying young person who is normally living with him (the 'normally living with test') … Rule 2·1 This Rule applies where (a) a child or qualifying young person normally lives with two or more persons in (i) different households, or (ii) the same household, where those persons are not limited to the members of a couple, or (iii) a combination of (i) and (ii), and (b) two or more of those persons make separate claims (that is, not a single joint claim made by a couple) for child tax credit in respect of the child or qualifying young person. Rule 2·2 The child or qualifying young person shall be treated as the responsibility of (a) only one of those persons making such claims, and (b) whichever of them has (comparing between them) the main responsibility for him (the 'main responsibility test')…".

Child tax credit (CTC) was introduced by the Tax Credits Act 2002 and was payable to one person only in respect of each child, even where the care of the child was shared between separated parents. The claimant father had two children. During the period between January 2004 and December 2005 (the relevant period), they lived with their mother but had very extensive contact with the father, who looked after them for at least three days a week. Throughout the relevant period, the father was in receipt of income support, contributory incapacity benefit and non-contributory disability living allowance. The father claimed CTC in respect of both children. His claim was refused by the defendant Revenue and Customs Commissioners (the Revenue) on the ground that the mother had the main responsibility for the children. The father challenged that decision on the ground that the rule that restricted entitlement to CTC to one household discriminated in favour of women. He succeeded in the appeal tribunal but failed before the Upper Tribunal and before the Court of Appeal. The father appealed to the Supreme Court.

The issues for consideration were: (i) what was the correct test for justification in cases involving discrimination in respect of state benefits; and (ii) whether the discriminatory provisions under the Child Tax Credit Regulations 2002, SI 2002/2007, as amended, which provided that the payment of CTC in respect of a child in shared care by two parents was to be made to the parent with main responsibility for the child (the no-splitting rule), was justified or whether the refusal of CTC to a father who looked after his children for three days a week was incompatible with his Convention rights against sex discrimination, as guaranteed by art 14 of the European Convention on Human Rights. The Revenue accepted that entitlement to CTC fell within the ambit of art 1 to the First Protocol of the Convention on Human Rights (protection of property (see R (on the application of RJM (FC) v Secretary of State for Work and Pensions [2009] 2 All ER 556]). Further, it was accepted that the relevant provisions that provided for single payment of CTC based on main responsibility were liable to have an indirectly discriminatory effect on male CTC claimants because experience showed that they were more likely than mothers to be looking after the child for the smaller number of days in the week.

HMRC contended that the "no-splitting rule" was justified in view of the fact that the CTC scheme was based on a policy aimed at reducing child poverty. Consideration was given to the decision of the Strasbourg court in Stec v United Kingdom (Applications 65731/01 and 65900/01[2006] All ER (D) 215 (Apr) (Stec) and to Runkee v United Kingdom(Applications 42949/98 and 53134/99) [2007] All ER (D) 175 (May) (Runkee).

Decision:

The appeal would be dismissed.

(1) The proper approach to justification in cases involving discrimination in state benefits was to be found in Stec. It was an established principle of law that a difference in treatment was discriminatory if it had no objective and reasonable justification. However, it was settled law that a wide margin was usually allowed to the state under the Convention when it came to general measures of economic or social strategy. It seemed clear from Stec that the normally strict test for justification of sex discrimination in the enjoyment of the Convention rights gave way to the "manifestly without reasonable foundation" test in the context of state benefits. The court would generally respect the legislature's policy choice unless it was manifestly without reasonable foundation.

In the instant case, if the principles for the test for justification had applied to the direct sex discrimination involved in Stec and Runkee, they had to apply a fortiori to the indirect sex discrimination. Stec v United Kingdom (Applications 65731/01 and 65900/01) [2006] All ER (D) 215 (Apr) adopted; R (on the application of RJM (FC) v Secretary of State for Work and Pensions [2009] 2 All ER 556 applied.

(2) The no-splitting rule was a reasonable rule for the state to have adopted and the indirect sex discrimination was justified.

The laudable aim and objective of the CTC was the lifting of the child from poverty. The state was entitled to conclude that it would deliver support for children in the most effective manner, that was, to the one household where the child principally lived. That would mean that that household was better equipped to meet the child's needs. It was a great deal simpler and less expensive to administer, thus maximising the amount available for distribution to families in that way. The ideal of integrating the tax and social security systems, so as to smooth the transition from benefit to work and reduce the employment trap, had been attractive to policy makers for some time. The introduction of CTC (and working tax credit) was a step in that direction. It was reasonable for government to take that step and to regard the targeting of child support to one household as integral to it. It was also reasonable for a government to regard the way in which the state delivered support for children, and indeed for families, as a separate question from the way in which children spent their time. The arrangements which separated parents made for their children were infinitely various and variable. Most parents could and did sort out those arrangements for themselves.

Only a small minority have to have those imposed upon them by a court, and even then they were free to change them if they both wanted to do so.

In the instant case, the court agreed with the Upper Tribunal and the Court of Appeal that the "no-splitting rule" had been a reasonable rule for the state to adopt and the indirect sex-discrimination was justified.

The appeal would be dismissed.

Comments – We do not see many cases involving tax credits because of the nature of the benefit and the level of the income of the recipients but this case which deals with the fundamental nature of the benefit has reached the Supreme Court as the Wilkinson case did in respect of the Widows Bereavement Allowance. Although conceptually taxation should be fair this demonstrates that in certain circumstances it is necessary for the practical application of the tax that it may be discriminatory.

Humphreys v Revenue and Customs Comrs [2012] UKSC 18

CAPITAL TAXES

Foreign currency bank accounts (Lecture P718 – 6.06 minutes)

Foreign currency bank accounts have caused many tax headaches over the last four years. Prior to FA 2008, they were less of a problem for UK-resident non-UK domiciliaries, given that such individuals always enjoyed the benefit of an annual CGT exemption (which of course non-UK domiciliaries, if they have opted for the remittance basis, nowadays do not).

The problem is that foreign currency is a chargeable asset for CGT purposes. Any withdrawal of funds from such an account represents a disposal on which a gain or loss can arise if, in the meantime, there has been a movement in the respective values of sterling and the foreign currency in question.

In their consultation paper dealing with the reform of the tax treatment of non-UK domiciliaries which was published on 17 June 2011, the Government confirmed that they intended to address this difficulty. Following further consideration, it has been decided that gains and losses on foreign currency bank accounts should be removed completely from the scope of CGT for:

(i) individuals;

(ii) trustees; and

(iii) personal representatives

in relation to disposals occurring on or after 6 April 2012 (Cl 35). This has been achieved by redrafting S252 TCGA 1992. It should be noted that the exemption, which was originally expected only to apply to individuals, has been extended to cover trustees and personal representatives as well.

It will be important not to overlook the fact that, in this context, losses will no longer be allowable, although, given sterling's recent track record against both the euro and the US dollar, this may not prove to be too much of a worry at the moment!

Contributed by Robert Jamieson

Incorporation relief for property businesses (Lecture P719 – 9.12 minutes)

<u>Background</u>

Capital gains tax (CGT) relief applies upon the incorporation of a business, where certain conditions are satisfied. *TCGA 1992, s 162* provides (inter alia) as follows:

> **"162 Roll-over relief on transfer of business**
>
> (1) This section shall apply for the purposes of this Act where a person who is not a company transfers to a company **a business as a going concern**…, together with the whole assets of the business, or together with the whole of those assets other than cash, and the business is so transferred wholly or partly in exchange for shares issued by the company to the person transferring the business" (emphasis added).

Unfortunately, there is no statutory definition of a 'business' for CGT purposes. It will often be clear whether what has been transferred to the company amounts to a business. However, there are some grey areas. One such area is whether an activity involving the receipt of rents for occupying land and buildings constitutes a 'business'.

HMRC's guidance on the meaning of 'business' for *TCGA 1992, s 162* purposes acknowledges that 'business' has a wider meaning than 'trade'. However, HMRC warns: "*It is a question of fact whether a particular activity constitutes a business. It is not easy to draw the line, but we do not accept that the passive holding of investments or the holding of properties as investments amounts to a business*" (CG65715).

No property 'business'

In *Ramsay v Revenue & Customs* [2012] UKFTT 176 (TC), the tribunal had to consider whether the appellant's activities as a landlord were a business of property letting such that incorporation relief was available under *TCGA 1992, s 162*, or whether the 'business' was more in the nature of an investment activity.

The property in question consisted of a sizeable Victorian property which had been converted into ten flats. The appellant pointed out to the tribunal that she and her husband spent approximately 20 hours per week carrying out various activities connected with the property, which were broadly as follows:

(1) Arranging to meet each tenant to explain that the rent must be paid on time, and also the accountant (who then was responsible for dividing the income);

(2) Checking and payment of quarterly electricity bills for the communal areas;

(3) Cancelling previous insurance policies and arranging a new policy;

(4) Attending the property to unblock the drains;

(5) Oiling and re-attaching steel wires on some of the garage doors belonging to the flats, and clearing debris in other garages;

(6) Returning post for previous tenants to the various senders;

(7) Confirming with the Council compliance with fire regulations, and installing/ replacing fire extinguishers, where applicable;

(8) Erecting a post and wire fence and hedging;

(9) Creating a flower bed;

(10) Pruning the shrubs around the property, sweeping up leaves and discarding in the local refuse tip;

(11) Weeding the back garden and car park on a regular basis;

(12) Bleaching the flagstones to the rear of the building to remove algae;

(13) Vacuuming and dusting the communal areas on a regular basis and polishing the mahogany staircase;

(14) Frequently checking the security of the windows and doors;

(15) Upon finding rubbish dumped in the building car park, taking it to the Council tip;

(16) Cleaning vacated flats and clearing furniture in preparation for new tenants;

(17) Providing additional assistance in particular to one elderly tenant (e.g. dealing with telephone calls regarding alleged faulty electricity supply, replacement of a broken window and even liaising with social services in relation to her care package).

The tribunal considered no fewer than ten different cases, although the cases mentioned by the tribunal were concerned with different legislative provisions. It quoted from the judgment of Lord Diplock in *American Leaf Blending Co. Sdn Bhd vs Director General of Inland Revenue* [1978] 3 All ER 1185, which HMRC also quotes in CG65715 as being a 'useful' authority for what is meant by a 'business':

> *"In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships' view, in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business."*

In addition:

> *"The carrying on of a `business', no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between. In the instant case, however, there was evidence before the Special Commissioners of activity in and about the letting of its premises by the company during each of the five years that had elapsed since it closed down its former tobacco business"*

The tribunal commented that what was transferred to the company upon incorporation was a large former residence which had been converted into ten flats. The activities listed were "normal and incidental to the owning of an investment property". The tribunal considered that there was a single investment property, and the scale of the property did not, of itself, convert the ownership of the property into a business. The taxpayer's appeal was dismissed.

<u>What matters?</u>

It would perhaps be interesting to speculate whether the decision in *Ramsay* would have been different if the appellant's ten flats were in different locations, rather than being part of a single property.

What is apparent is the importance not only of the number of hours engaged in the 'business', but also the specific activities performed by the landlord during that time.

The income tax legislation identifies a UK property business in the following terms (*ITTOIA 2005, s 264*) (nb there are parallel provisions for overseas property businesses in *ITTOIA 2005, s 265*):

> **"264 UK property business**
>
> A person's UK property business consists of—
>
> (*a*) every business which the person carries on for generating income from land in the United Kingdom, and
>
> (*b*) every transaction which the person enters into for that purpose otherwise than in the course of such a business."

The tribunal in *Ramsay* sought to distinguish between a 'business' for the purposes of *TCGA 1992, s 162* relief, and a "normal Schedule A taxable concern" under (what was then) *ICTA 1988, s 15*. On that basis, a 'business' for income tax purposes is not necessarily a business for incorporation relief purposes. The degree of activity involved in conducting the business would seem to be the major distinguishing factor.

A statutory definition of 'business' for CGT purposes is needed, or at least some specific, meaningful guidance on what HMRC considers constitutes a business for incorporation relief (and other) purposes.

Contributed by Mark McLaughlin

Non-UK domiciled spouses **(Lecture P720 – 5.56 minutes)**

After 30 years, the Government at last intend to consult on the possibility of increasing the £55,000 exempt amount which a UK-domiciled individual can transfer to his non-UK domiciled spouse under S18(2) IHTA 1984. Remember that this is a cumulative figure and covers all lifetime gifts – there is no seven-year rule here – as well as the transfer on death.

As one commentator has remarked:

'An increase is welcome because this restriction is not widely known outside professional advisers and a UK-domiciled individual with a non-UK domiciled spouse is at risk of a serious charge (being virtually 40% of his worldwide assets) because of the absence of any meaningful spouse exemption.'

The rumour is that the exemption will be increased to £325,000 (although the authority for this figure is unclear). However, for a wealthy couple, such an increase would not be that much of a help. Where clients need to be on their guard is in connection with a related proposal from HMRC. The plan is apparently to allow individuals who are domiciled outside the UK and who have a UK-domiciled spouse to elect to be treated as domiciled in the UK for all IHT purposes. This is superficially attractive, given that it would then allow the couple to avoid an IHT charge on the first death, with the downside being that the whole of their joint assets on a worldwide basis would then be brought into charge on the second death. This might be acceptable if the non-UK domiciled survivor was able subsequently to revoke the election and revert to their original domicile status, but it is hard to imagine that such a possibility would be permitted. This is an idea which needs careful watching.

Contributed by Robert Jamieson

R&C Brief 14/2012 Beneficial ownership and tax treatment of Depositary Receipts

HMRC is revising its Capital Gains Manual guidance on how holding shares in the form of Depository Receipts (DRs) will affect liability to CGT or corporation tax following the Tribunal decision in HSBC/BNY Mellon. Although this case concerned SDRT, it has caused HMRC to review its position on beneficial ownership. In outline, HMRC will continue to regard the holder of DRs issued in the UK as beneficial owner of the underlying shares. A transfer of shares in exchange for DRs is not a disposal for capital gains purposes; a disposal of the DRs is a disposal of both the DRs and the underlying shares; and where DRs are issued instead of shares in a share exchange or company reconstruction, the shares will be treated as issued to the shareholders.

ADMINISTRATION

How far does the responsibility for tax advice extend?

The claimants were the executors and daughters respectively of the deceased (CS) who died during a heart operation. CS had been a successful businessman, having been managing director and principal shareholder of a family company. His daughters were minority shareholders. CS had wished to sell the business by way of a management buy-out (MBO), and had instructed the defendant firm of solicitors to act for him and his daughters in that transaction. The main contact that CS had had with the defendant had been through a partner (H). Terms of engagement had set out the anticipated legal work required to complete the MBO. H had involved the defendant's tax department in dealings with CS and his daughters, and separate tax advice files had been opened and tax advice given in regards to the proposed MBO transaction.

Two weeks before the MBO was to have been completed, CS emailed senior members of the MBO team, as well as other individuals involved in the company, to advise them of an operation that he was due to have in the month following completion of the MBO. In the email, CS had anticipated that the operation would cause problems with him being able to attend meetings. A senior member of the MBO team had responded in regard to an issue concerning a possible bank subordination, to which CS had replied. In that reply CS had "blind-copied" H. Although H had been aware of CS's history of ill-health, that had been the first knowledge that H had had about CS's operation. The MBO was duly completed and the necessary transfers took place. Following which, CS had had his operation, but died during the procedure. The result of his death after the completion of the MBO was that the proceeds of sale of his shares had become liable to inheritance tax. On that basis, the claimants issued proceedings contending that had the defendant given due advice on the tax consequences in the event of CS's death, the MBO would have been deferred until after the operation had taken place.

They alleged that the defendant ought to have advised CS and his daughters of the tax consequences and to have delayed the sale. The defendant denied that it had been negligent. The judge found that the email, to which the defendant had been "blind-copied", had not initially been sent to H and had not included a request by CS for advice arising out of it. The reason why CS had copied H in on the email was to bring his attention to the issue of the bank subordination. Further, given the manner in which the knowledge of the operation had been received by H, the judge considered that receipt of the email had not triggered any duty on the part of the defendant to advise CS and his daughters as to the tax consequences if CS were to die during the operation. He therefore dismissed the claim. The judge subsequently made a costs order that the claimants pay 50% of the defendant's costs. He had reached that conclusion on the basis of an issue-based approach, and also, as the judge had found, because the defendant had been unreasonable in refusing to mediate. The claimant appealed the judge's primary findings. The defendant cross-appealed the judge's costs order.

On the appeal, the claimants submitted that the receipt by H of the chain of emails should have alerted him to the risk accompanying the heart operation, and accordingly H should have advised, or have asked his tax department to consider advising delaying the MBO due to tax consequences. On the cross-appeal, the defendant contended that the judge had erred first, in taking into account relatively peripheral background matters which had not justified so large a reduction in the award of costs, and secondly, in the exercise of his discretion by finding that the defendant had been unreasonable in refusing to mediate.

Decision:

1st Ground

The judge had been entirely right to attach great weight to the fact that the email that had indicated the forthcoming operation had only reached H by CS subsequently copying him in on it, and in circumstances where CS had not been seeking or asking for any advice in the light of the forthcoming operation. On the contrary, H had only been copied in on the email chain because of the point concerning the possible bank subordination. There had simply been nothing from the email to have caused or required H to give further advice or to have sought further consideration from his tax department. There had been nothing in the email to indicate that the operation had carried any significant risk. CS had never expressed any concerns to the defendant, let alone sought advice about any implications.

The appeal would be dismissed.

2nd Ground

The judge had, in the circumstances, been entitled to approach matters as he had and there was no reason for the instant court to interfere. At all stages during the litigation the parties had been far apart in terms of any settlement. The defendant's assessment of the strength of the claimants' case on breach of duty had never altered. It had been difficult to see, given the circumstances, how a mediation could have had reasonable prospects of success. Moreover, in the circumstances, the defendant's refusal to agree to a mediation had not been intransigent. Nothing had changed in the case to necessitate a re-evaluation on the question of liability. A reasonable refusal to mediate would not become unreasonable simply by being steadfastly, and for cause, maintained. It had not been shown that the defendant, as the successful party, had acted unreasonably in refusing to agree to a mediation. The judge had been wrong to bring into account, adversely to the defendant, the defendant's attitude to mediation in deciding what costs overall should have been awarded.

The cross-appeal would be allowed. Exercising the discretion afresh, the defendant would be awarded 60% of its costs of the proceedings.

Decision of Arnold J [2011] STC 1177 Affirmed In Part.

Comments - Allegations of professional negligence are always a matter of concern to tax advisers. The fact that this claim was taken as far as the CA suggests that a practitioner giving advice on IHT planning needs to make it very clear that much IHT planning is dependent on the transferor surviving for seven years. The duty of skill and care that are required by advisors nowadays is extensive – we have three cases in two months dealing alleged negligence and going through more than one court level. Hence risk management procedures are required on a daily basis to protect one's professional life.

Swain Mason and ors v Mills Reeve (A Firm) [2012] EWCA Civ 498

Genuine and reasonable belief "reasonable excuse"

On 18 May 2010, a day before the statutory deadline for filing its end of year return of payments under PAYE ("P35"), the appellant company logged onto the HMRC site and purported to send its PAYE return online. The company received an email acknowledgement which stated "Thank you for sending the PAYE End of Year submission online. The submission or reference was successfully received on 18-05-2010. If this was a test submission, remember you still need to send your actual Employer Annual Return using the live transmission in order for it to be processed." As a result the company believed its return had been submitted successfully.

In September 2010 HMRC issued a £400 penalty on the company for not filing the P35 on the basis that (i) the return was sent in "test" mode; (ii) a reasonable employer who had properly considered HMRC's online guidance on the BusinessLink site and replicated on the HMRC website, would have been prevented from believing a return had been delivered when it had accidentally been submitted in "test" mode; and (iii) a "reasonable excuse", for the purposes of TMA 1970 s 118(2), was an exceptional event beyond a person's control which prevented the return from being filed by the due date, ie severe illness or bereavement, and not a belief that he had submitted the return online. The appellant appealed unsuccessfully to the First-tier

Tribunal (see [2011] UKFTT 518 (TC)). On the appellant's appeal to the Upper Tribunal, the tribunal took the view that there was an error of law in the decision and that it should therefore be reviewed. The outcome of that review was that the decision should be set aside and the appeal considered afresh. At the appeal before the First-tier Tribunal the following issues arose for consideration, whether: (i) a return sent in "test" mode was "delivered" and "accepted" for the purposes of reg 192 of the Income Tax (PAYE) Regulations 2003, SI 2003/2682; and (ii) a reasonable belief could amount to a "reasonable excuse".

Decsion:

On its proper construction, it was clear that the word "accepted" in reg 192 of the 2003 Regulations meant something more than "delivered". The Oxford English Dictionary's definitions of "accept" included: "to take or receive (something offered) willingly"; "To consider or recognize (a person or thing) to be a specified thing, or to have a specified quality"; "to take as authentic, valid, or adequate; to believe (a statement or theory)"; "to consent"; or "to agree (in the context of a writ) to consider as validly served". Those definitions showed that for a proffered item to be "accepted", the recipient had to agree or consent to take the item: mere receipt was insufficient. In the instant case the return was sent in "test" mode. Although it was clear from the "successful submission receipt" that "the submission … was successfully received", the P35 was not actioned by the HMRC system because it was not treated as a final submission. It was not "taken as … valid or adequate". Through its computer system, HMRC did not "consent" to treat it as a submitted P35. Accordingly, taking into account both the statutory context and the Dictionary definitions, the P35 was not "accepted" by the HMRC computer. As a result it was deemed not to have been delivered even though it was, as a question of fact, received by the HMRC computer. Accordingly the company's P35 return was delivered late.

A reasonable employer would not have been alerted by HMRC's online guidance to the risk of accidentally sending a test return. It was only if the employer read the FAQ on "Can I send a test submission" that he found that there might be a problem; however, that begged the important question why would a reasonable employer, uninterested in test returns, read that FAQ at all? Moreover, the reasonable employer who had received a "successful submission receipt" and believed he had sent a live return, was not unsure whether he had sent a live return—he had no reason to think he had sent a test return at all. Furthermore, given the quality of the online guidance, and his receipt of the "successful submission" receipt, the company's belief that it had submitted its P35 was reasonable.

A genuine and reasonable belief was sufficient to amount to a "reasonable excuse" for the purposes of TMA 1970 s 118(2). On the facts, the company genuinely and honestly believed that the P35 had been filed. That provided the company with a reasonable excuse for the late filing of the return. It followed that the appeal would be allowed.

Appeal allowed.

Comments – The case demonstrates how important the concept of reasonable excuse is as a defence in respect of many provisions in taxation. The concept has been around a long time and was defined firstly in VAT and then imported into various aspects of the new penalty regime. It is important in an electronic filing system that the taxpayer has certainty over whether the relevant reporting has been accepted as filed by HMRC. Accordingly Tribunal Judge Anne Redston deliberated hard on the meaning of reasonable excuse as the defence. As with a number of other Tribunal judges she has not restricted the interpretation of reasonable excuse to the limits that HMRC allege. This is important as this goes to the root of determining whether a taxpayer has taken the appropriate care or has been careless.

Lifesmart Limited v Revenue and Customs Comrs TC 1832

Failure to operate PAYE – Shadow directors are employees

Five companies, which traded in tickets for various events, went into liquidation. The Official Receiver formed the opinion that all five companies had been under the control of an individual (R), who had been a director of one of the companies and had acted as a 'shadow director' of the other companies. HMRC issued determinations under Income Tax (PAYE) Regulations SI 2003/2682, reg 80, and issued a notice of direction under reg 81(4) requiring R to pay the tax in question. R appealed, denying that he had been a shadow director of two of the companies.

Decision:

The First-tier Tribunal reviewed the evidence in detail and upheld the direction in principle, finding that R had been 'a shadow director and thus an employee' of the two companies in question. (However, the tribunal reduced the amounts assessed from £525,808 to £324,600.)

Comments - SI 2003/2682, reg 80 provides that where it appears that an employer has not paid or accounted for PAYE, HMRC may issue a determination of the amount of tax payable. Regulation 81 provides that where the employer does not charge tax, the tax may be recovered from the employee if he 'received those payments knowing that the employer has wilfully failed to deduct the amount of tax which should have been deducted'. The First-tier Tribunal upheld HMRC's view that that condition was satisfied in this case, finding that the appellant had been 'a shadow director and thus an employee', so that the companies should have deducted PAYE from the amounts which they had paid him, and also finding that the appellant had been aware of this.

M Rangos v HMRC TC01893

Can taxpayers rely on published concession and legitimate expectation?

There were two separate sets of proceedings raising the same issue.

The first claimant from the first set of proceedings (the first claimant) worked as a seafarer between 1974 and 2007. In 2006, Seatax Ltd, a company with the specific aim of providing advice to seafarers about their personal taxation, submitted the first claimant's tax return for the tax year ended 5 April 2006. In the tax return, the first claimant claimed seafarer's earnings deduction (hereinafter referred to as SED) in the sum of £72,936. Section 378(1) of the Income Tax (Earnings & Pensions) Act 2003 made it clear that SED was allowed only if three criteria were met. One of those criteria was that the person making the claim performed duties as a seafarer “in the course of an eligible period”. Section 378(2) explained what was meant by the phrase “eligible period”. An eligible period was calculated by reference to “days of absence from the United Kingdom”. A person was absent from the United Kingdom only if s 378(4) was satisfied. Under that subsection, a person was regarded as being absent from the UK on any day only if he was absent “at the end of the day.” In order to determine the meaning of “at the end of the day”, the defendant Revenue and Customs Commissioners (the Revenue) in 1987, published a document, form S203(New). That was followed by form P84 and then “the Blue Book”. It was stated was that a voyage which did not extend to a foreign port might still count towards a day of absence (the broad concession).

The claimant in the second set of proceedings (the second claimant) was a seafarer since about 1975. For each of the tax years from 2001–2007 the second claimant made claims for SED and its predecessor, Foreign Earnings Deduction (FED). Following an enquiry, the Revenue disallowed the entirety of the claims in respect of both claimants. The claimants brought judicial review proceedings challenging the lawfulness of the Revenue's decisions to disallow their claims for SED/FED.

The claimants argued, inter alia, that at the time they made their claims to the deduction they held a legitimate expectation that the Revenue would uphold them on the basis of the broad concession. The Revenue argued, inter alia, that even if the broad concession properly founded a legitimate expectation upon which the claimants relied they should not be bound by the concession once they had written to the claimants denying the existence or application of the broad concession. The issues were whether if the claimants acquired a legitimate expectation that he would be taxed in accordance with the broad concession, whether there came a time when the legitimate expectation ceased.

Decision:

A taxpayer was entitled to rely upon a statement made in a formal publication unless and until the statement was revoked, withdrawn or altered in a prescribed manner. If a taxpayer legitimately relied upon a statement made by the Revenue which was contained within a document published by the Revenue and aimed at a class of taxpayers of which the taxpayer was one, reliance upon the document ought not to regarded as unreasonable simply because an employee of the Revenue expressed a view which was contrary to that contained in the document.

In the instant case, on any fair reading of the contents of Form S203 (New), it included a statement of the broad concession. Further, the Blue Book set out the terms of the broad concession unequivocally. As from the date of the first publication of the Blue Book at the very latest there was in being a clear statement of the broad concession published in a document which was specifically intended to assist seafarers who wished to claim FED. There was nothing in the evidence which suggested that sometime thereafter the Revenue published a document aimed at eligible seafarers which revoked or altered the effect of the broad concession or suggested that the Blue Book was obsolete or superseded.

Both claimants would succeed in their claim for judicial review.

Comments - This is an important decision on the principle of 'legitimate expectation'. The QB held that the relevant HMRC publication had given the claimants a legitimate expectation that their claims would be allowed. The facts here can be contrasted with last year's Supreme Court decision in Davies, James and Gaines-Cooper, where the Court held that IR20 did not give rise to any such expectation.

Cameron and ors v Revenue and Customs Comrs [2012] EWHC 1174 (Admin)

Penalties are appropriate

HMRC enquired into the partnership returns of a Chinese takeaway restaurant for the years 2002/03 to 2007/08. Enquiries were also opened into the corresponding personal tax returns of the three partners (one of whom was deceased). In essence, HMRC were concerned that takings had been suppressed. After two years, HMRC amended the returns and imposed penalties on two of the partners (not the deceased) for negligent delivery of incorrect returns.

The taxpayer partnership appealed.

Decision:

The First-tier Tribunal found that the partnership returns were incorrect and that this was caused by fraud or negligence on the part of the deceased partner. However, it decided that HMRC's amendments were excessive and said that the adjustment should be based on alternative calculations set out by the tribunal.

With regard to the penalties which had been set at 40%, the tribunal considered this level to be in order on the basis that the inaccuracies had been deliberate and the level of co-operation by the appellant had been 'extremely poor'.

The taxpayer's appeal was allowed in part.

Comments – The case demonstrates the difficulties involved in cases where the failure to declare the right amount of profits is due to a party who is deceased particularly when the penalty is being levied on the remaining partners. The case also demonstrates the detail that is required to be proved by HMRC when alleging that the wrong amount of income has been declared.

The Red Star (a partnership) TC1648

Payment by CHAPS

A company appealed against a default surcharge, contending that it had a reasonable excuse because it had instructed its bank to make payment by CHAPS, but the bank had failed to implement this instruction.

Decision:

The First-tier Tribunal accepted the company's evidence and allowed its appeal.

Comments - There have been conflicting decisions on whether there is a reasonable excuse for late payment of VAT where the appellant has been let down by its bank. In this case, where the company's bank failed to implement an instruction to make payment by CHAPS, the Tribunal accepted the company's contention that it had a reasonable excuse for the late payment.

Banham Patent Locks Ltd v HMRC (TC01929

Scotland Act 2012

The Scotland Act devolves new tax-making powers to Scotland. It includes new powers to set a Scottish rate of income tax on earned income up to 10p lower or higher than the UK rate and to introduce new property taxes have been agreed. Powers on air guns, drink driving and speeding limits have also been devolved.

The legislation is based on the final report of the Calman Commission, which was established by an opposition Labour Party motion in the Scottish Parliament in December 2007, against the wishes of the Scottish National Party minority government.

Scottish ministers will be able to raise up to £2.2 billion for capital projects independently of HM Treasury and will in addition be able to borrow up to £500 million from the UK government.

The Act will allow Scotland to introduce its own land transaction tax and landfill tax. It would be able to abolish stamp duty land tax should it wish.

The Scottish government will be able to set a rate of income tax up to 10p higher or lower than UK rate.

These powers will apply from April 2015.

The Act also devolves powers of air guns, drink driving and speeding limits.

It provides a new appeal right to the Supreme Court for questions raised in Scottish criminal proceedings about compatibility with the European Convention on Human Rights or EU law. The Act also provides for a review of these provisions and a power for the Secretary of State to amend them following the review.

The Act gives the Scottish government a role in appointments in broadcasting and the Crown Estate.

Scottish MSPs had been demanding devolved powers over corporation tax and excise duties, although these were never part of the Bill. These areas have not been included which some regard as a "missed opportunity".

Proposed reservations on insolvency and health regulation were removed. The Scottish Government retains its power in these areas.

Penalty for late submission of CT return

A company (P) had used its accountant's address as its registered office. During 2007 the accountant ceased to act for P, and in April 2008 P changed its registered office to the address of its controlling director (H). In the meantime, in September 2007 HMRC had issued P with a notice requiring it to file a corporation tax return for the period ending 30 August 2007. P's former accountant failed to forward this notice to H. In September 2008 HMRC imposed a penalty of £100. Since P had not informed HMRC that it had changed its registered office, HMRC sent the penalty notice to P's former registered office. At some time in 2008 Companies House informed HMRC that P had changed its registered office, and HMRC began sending correspondence to P's new registered office. P appealed against the penalty which HMRC had imposed in September 2008, and against subsequent penalty notices.

Decision:

The First-tier Tribunal allowed P's appeal. Judge Redston rejected HMRC's contention that the effect of TMA 1970 s 115(2)(a) was that the notice had been validly served by being sent to P's last known registered office, and held that the phrase 'usual or last known place of residence' was only applicable to sole traders and partners, and did not include companies. She held that, although it was 'possible validly to serve a notice by delivering it to the company's registered office, to its place of business, or by effectively communicating the notice in some other way', a notice was 'not served on a company merely by delivering it to its “last known” registered office'. She also expressed the view that it was likely that Companies House had informed HMRC of P's change of registered office before the issue of the penalty notice, although HMRC had not updated its records until after the issue of the notice. On the evidence, she found that while the notice to file the return had been validly served (by being sent to the accountant's address which was P's registered office at the time of issue), the penalty notice had not been validly served because it had been sent to P's old registered office.

Comments - This is a somewhat controversial decision because Judge Redston specifically rejected HMRC's long-standing interpretation of TMA 1970 s 115(2). It is understood that HMRC intends to appeal to the Upper Tribunal. The judge used common sense in applying the decision. Although it is against HMRC’s long standing interpretation in today’s joined up society with the records available to the Government through its various organs sending a notice to the company’s last known address is not really appropriate.

Partito Media Services Ltd v HMRC TC01949

Late return: reasonable excuse

A pensioner had for many years employed an accountant to deal with his tax returns. For financial reasons, he decided that he would no longer use the accountant's services and planned to complete his 2009/10 return himself.

He anticipated requiring HMRC's help, but had not expected there would be a problem in visiting an office on 31 January 2011 for this purpose. When he contacted HMRC, the earliest appointment available was for 3 February. He accepted the appointment, but as a result, his return was submitted three days late.

HMRC issued a late filing penalty, against which the taxpayer appealed.

Decision:

The First-tier Tribunal concluded from HMRC's evidence that the taxpayer's local enquiry office did not offer a service whereby taxpayers could attend in person and file their return with the help of HMRC staff. The department said that a 'prudent taxpayer' should have known that it would be impossible to obtain assistance so close to the tax return filing deadline. In response, the tribunal said there appeared to be no publicity material issued by HMRC relating to how far in advance appointments should be booked.

The tribunal judge decided that the taxpayer would have accepted an appointment on 31 January, had one been available, and would have then filed on time. His return was late because of HMRC's lack of availability. The taxpayer had a reasonable excuse and the penalty was quashed.

The taxpayer's appeal was allowed.

Comments - The appellant was a pensioner with a very small tax liability, who could not afford an accountant and wanted to make an appointment with an HMRC officer to ensure that he had completed his return correctly. HMRC does not have sufficient staff to see every unrepresented taxpayer on 31 January, and therefore made an appointment with the appellant for 3 February. More controversially, HMRC took the view that the appellant should have sought an earlier appointment, and imposed a penalty on the basis that he was three days late in submitting his return. The First-tier Tribunal allowed the pensioner's appeal, holding that the fact that he had sought an appointment before the 31 January deadline, but had not been given an appointment until after the deadline and had delayed submitting his return until the appointment, constituted a reasonable excuse. This was not an appropriate case for the imposition of a penalty.

J Bentley v HMRC TC1927

CIS deductions on account of tax not sufficient

A company (F) operated the construction industry scheme. HMRC formed the opinion that, in accounting for tax under the scheme, it had overstated the amounts of the payments it made which represented the cost of materials, and had therefore not deducted sufficient tax from the payments it made to its contractors. They issued determinations under SI 2005/2045, reg 13 to recover the tax.

Decision:

The First-tier Tribunal dismissed F's appeal against the determinations. Judge Poole observed that FA 2004 s 61(1) required a deduction to be made from all payments made to subcontractors, except for 'any part of the payment which is shown to represent the materials cost'. He held that 'the word “shown” in this context connotes the satisfactory demonstration by appropriate evidence of the relevant facts, in a way which can be properly evaluated not just by the contractor but also by HMRC and, if necessary, the Tribunal.' F had failed to submit satisfactory evidence to displace the determinations. (The Tribunal also dismissed an appeal against the cancellation of F's gross payment status.)

Comments - FA 2004 s 61 provides that, where a contractor makes a 'contract payment', he must deduct 'a sum equal to the relevant percentage of so much of the payment as is not shown to represent the direct cost of any other person of materials used or to be used in carrying out the construction operations'. HMRC issued assessments on the basis that the company here had overstated the amounts attributable to 'materials'. The First-tier Tribunal upheld the determinations, finding that the company had failed to submit satisfactory evidence to justify its claim that payments it had made to subcontractors were attributable to 'materials'.

Flemming & Son Construction (West Midlands) Ltd v HMRC TC1900

BUSINESS TAX

Risk-based Approach to IR35 **(Lecture B717 – 13.36 minutes)**

HMRC has published a 47-page guide to its risk-based approach to checking compliance with the IR35 legislation. It sets out three risk bands and explains how to work out which risk band applies and what they mean. The guide provides examples in the form of a number of scenarios to illustrate when and why IR35 will apply to an engagement. It also very clearly sets out what the guide is intended to do and what it is not intended to do.

HMRC will use three risk bands: low risk, medium risk and high risk. The bands provide an indication of the risk that HMRC will check whether IR35 applies in a particular case.

A set of 'business entity' tests have been developed in conjunction with the IR35 Forum to determine which risk band applies.

The tests are voluntary and there is no need to inform HMRC of the result. They look at a business as a whole to gauge how likely it is that the business has entered into an engagement to which IR35 applies; they do not focus on individual engagements.

If HMRC think that IR35 may apply, the taxpayer will be asked whether they have thought about IR35. If the trader replies that they are outside IR35, HMRC will request evidence.

If HMRC are satisfied that the trader is outside IR35 or in the 'low risk' band, then it will close the IR35 review, and undertake not to check again whether IR35 applies for the next three years, (which is evidenced in the form of a certificate) provided that:

- the information given to HMRC is accurate; and
- the individual's circumstances and, in particular, the working arrangements do not change in that time.

Otherwise HMRC will continue the IR35 review and seek further evidence so that a judgement can be made on whether IR35 applies.

If either the 'high risk' band or the 'medium risk' band applies, HMRC says that there is a risk that it will check whether IR35 applies and that this risk is not low.

The guide highlights that each engagement needs to be considered separately. It points out that some businesses have all their engagements outside IR35; some businesses have all their engagements within IR35 and some businesses have not only engagements outside IR35 but also engagements within IR35. The guidance should be applied on an engagement by engagement basis.

The business entity tests

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There are 12 tests. Each of the 12 tests asks at least one question. A 'Yes' answer to the relevant question scores a number of points. Different tests give different scores and the total number of points determines which risk band applies.

Total score from the tests	*Risk band*
Less than 10	High risk
10 to 20	Medium risk
More than 20	Low risk

The individual tests;

1. The Business Premises test: Does your business own or rent business premises which are separate both from your home and from the end client's premises? 10 points
2. The PII test: Do you need professional indemnity insurance? 2 points
3. The Efficiency test: Has your business had the opportunity in the last 24 months to increase your business income by working more efficiently, e.g. by finishing a fixed-price contract early? 10 points
4. The Assistance test: Does your business engage any workers (other than shareholders/directors/ partners) who bring in at least 25% of your yearly turnover? 35 points
5. The Advertising test: Has your business spent over £1,200 on advertising in the last 12 months? 2 points
6. The Previous PAYE test: Has the current end client engaged you: on PAYE employment terms, within the 12 months which ended on the last 31 March, with no major changes to your working arrangements? minus15 points
7. The Business Plan test: Does your business have a business plan with a cash flow forecast which you update regularly? Does your business have a business bank account, identified as such by the bank, which is separate from your personal account? 1 point if the answer to both questions is yes.
8. The Repair At Own Expense test: Would your business have to bear the cost of having to put right any mistakes? 4 points
9. The Client Risk test: Has your business been unable to recover payment for work done in the last 24 months or more than 10% of yearly turnover? 10 points
10. The Billing test: Do you invoice for work carried out before being paid and negotiate payment terms? 2 points
11. The Right of Substitution test: Does your business have the right to send a substitute? 2 points
12. The Actual Substitution test Have you hired anyone in the last 24 months to do the work you have taken on? 20 points

It is worth noting that there would clearly be a degree of similarity between the tests that would be applied when determining status in employment v self employment situations. These tests are well reported in many cases and of course can be identified from the HMRC website. However there seems to be the inclusion of a number of arbitrary tests. Many businesses do not require PII so it seems strange that it should be included. One can understand the potential inclusion of advertising but it raises a number of questions such as why is advertising relevant to a business that gets all its work from recommendation? And why is there the arbitrary level of £1,200 in the last twelve months?

It also seems strange that there are obvious tests which should have made it onto the list but did not such as

- supplying goods to your clients at a profit;
- providing your own equipment and running costs to do the work;
- working for multiple clients and controlling the hours you work for them;
- charging by time worked;
- working for clients without a contract verbal or written.

The list will, no doubt, be developed over a period of time.

Additionally where a points means prizes approach is adopted with the prize of course being that the more points you earn leading to the less chance HMRC will want to investigate your tax affairs it raises the issue of the weighting in terms of points. With tests like these it will be interesting to see what methods of "beating" them develop such a large number of sub-contractors renting space at the same time in a property (probably small to keep the costs down).

The Overview of Tax Legislation published in the March 2011 Budget laid out the terms of reference for the IR35 improvement project:

- To provide greater pre-transaction certainty, including a dedicated helpline staffed by specialists
- To provide greater clarity by publishing guidance on those types of cases HMRC view as outside the scope of IR35
- To restrict reviews to high risk cases carried out only by specialists teams; and
- To promote more effective engagement with interested parties through an IR35 Forum to monitor HMRC's new approach.

This is precisely what it has delivered.

It is worth noting that as part of the IR35 improvement package, around 36 specialist staff will be organised into three teams based in Salford, Edinburgh and Croydon. When they pick up a case for enquiry, the teams will take into account a contractor's reasoning and evidence why IR35 does not apply to them rather than asking for a long list of documents, HMRC said.

This guidance is intended to be helpful, although it is purely guidance and is not based on law. It represents a step forward but there is a long way to go potentially before IR35 is perceived to be successful.

Contributed by Tony Jenkins

Taxation of Controlling Persons

In May in addition to the consultation document which sets out the business entity tests for determining the risk bands for IR 35, HMRC has published a consultation document which proposes that 'controlling persons' should have income tax and NICs deducted at source by the engaging organisation where their services are provided through an intermediary.

This is, of course, coming on the heels of the disclosure that over 2,000 people are operating through Personal Service Companies (PSCs) inside Government as did Ed Lester, CEO of the Students Loans Company, who announced his intention to step down. The Government view is that where an individual has the requisite level of control to direct the activities of the organisation and they are engaged at a senior level (through an intermediary) then that individual should be taxed as an employee.

The application of the IR35 rules is not viewed as an adequate response because the IR35 rules place the obligation on the intermediary to operate income tax and NICs in the relevant circumstances, rather than the engaging organisation. Consequently there is inadequate clarity and transparency.

New legislation is proposed which would require the engaging organisation to place all controlling persons on the payroll. This provision would apply even where they might be working through a personal service company (PSC) for other purposes and even if the payments made by the engaging organisation were made to the PSC and not directly to the individual worker.

This would mean the whole amount paid by the engager to the PSC would be treated as remuneration of the controlling person as if they were an employee. The controlling person would have income tax and NICs deducted at source by the engaging organisation. This would effectively mean that the worker would be taxed in the same way as employees of the organisation.

It is proposed that a controlling person be defined as someone who is able to shape the direction of the organisation having authority or responsibility for directing or controlling the major activities of the engaging organisation during the year. This would be someone who has managerial control over a significant proportion of the organisation's employees and/or control over a significant proportion of the budget of the organisation.

Micro businesses which engage controlling persons through an intermediary would be excluded. A micro business is defined by the EU as a business which employs fewer than 10 persons and whose turnover and/or balance sheet does not exceed €2m (approximately £1.7m.). The exclusion would not apply to micro businesses that are part of a group structure.

This will no doubt spark real interest particularly for those affected by the provisions. The consultation which appears to have been rushed out with errors in some statutory references ends on 16 August 2012 right in the middle of the holiday season so there may be fewer comments than usual.

Contributed by Tony Jenkins

Tests indicate employment

The taxpayer was a property development and letting business. In 2004, it took on F as a general labourer on a flexible basis. It was agreed that F would be treated as self-employed. Although it was necessary to supervise his work initially as he was not skilled at the outset, this became less necessary as he became more experienced. He was paid on a weekly basis and received no holiday or sickness entitlement.

Each job he undertook was arranged individually, with the taxpayer stating the amount that would be paid. The taxpayer supplied the heavy equipment, but F provided his own hand tools. He was covered by the taxpayer's insurance while working on the taxpayer's properties.

HMRC disagreed that F was self-employed and issued determinations on the employer stating F was an employee and that PAYE and National Insurance should be paid. The taxpayer appealed.

Decision:

The First-tier Tribunal found that F was an employee. First, applying the control test, it was clear that the taxpayer had to supervise F when he was first engaged and this status was largely unchanged. Second, F was not free to substitute another person to do his work for him. Third, F was not conducting his affairs in the way of a self-employed person. He was not exposed to any substantial risk, he did not hire assistants, and he was financially dependent on the taxpayer. He was paid a stated amount for each job, he kept no business records, and did not advertise for work. Although he was not entitled to holiday or sick pay, this was consistent with the nature of the arrangements between the taxpayer and F.

The only test that indicated self-employment was the intention of the parties, but this would only be relevant if other tests were inconclusive. F was an employee, so the taxpayer's appeal was dismissed.

Comments – As demonstrated in this case there are specific tests that have been built up over a period of time which are good parameters in determining whether there is an employment or self employment. You will note that ironically we have this case and the next dealing with the issue in the same month as we have included details of the new "IR35 Business entity tests" which are completely different. However the parameters that tribunal use in determining status were formally laid out by the then President of Special Commissioners in April 2002. There are 15 factors taken into consideration arising out of previous case law and the three referred to above are well known from Ready Mixed Concrete case in the 1950s.

Eric Newman Developments Ltd TC1807

Dancer at club: whether employee

A company (S) operated two 'gentlemen's entertainment clubs' in London. It arranged for young women to dance at the clubs, and treated them as self-employed. The dancers received payments from customers at the clubs, in the form of vouchers which S distributed. A dancer (Q), who had worked at one of the clubs from June 2007 to December 2008, took proceedings against S in the Employment Tribunal, contending that she had been an employee of S and had been unfairly dismissed.

Decision:

The Employment Appeal Tribunal held that Q had been an employee, and remitted the case to the Employment Tribunal to determine whether she had been unfairly dismissed.

Comments - Although this is not a tax case, it is a significant decision on employment status. The Employment Appeal Tribunal reversed the Employment Tribunal decision and held that the dancer had been an employee of the company. This has significant implications for similar cases, as it has been customary for such clubs to treat their dancers as self-employed.

NE Quashie v Stringfellows Restaurants Ltd (Employment Appeal Tribunal)

Partners or not? A question of fact

The taxpayer and her husband (V) had been in partnership as landscape gardeners until the business ceased in 2002. The couple separated for a period, but in July 2003, V persuaded the taxpayer to give the marriage a further try. She agreed, but on the basis that they move away from London. They moved to Yorkshire where V began his own landscape business. The taxpayer was adamant that she would not be engaged in the business, but did assist in it. For example, she bought two vehicles which she made available to V, and helped with banking arrangements.

The business ceased in the year ended 5 April 2008, but for its duration V submitted no income tax, PAYE or VAT returns. He did not deduct tax and National Insurance from employees' salaries.

In 2010, HMRC enquired into V's tax affairs. This resulted in VAT and income tax assessments being raised on the basis that V and the taxpayer conducted the business in partnership. The taxpayer appealed, claiming that she had not been V's business partner.

Decision:

The First-tier Tribunal did not agree with HMRC that the taxpayer had been in business with V. The judge believed the taxpayer's assertion that she would never contemplate being in partnership with her husband. It was clearly his business. The taxpayer had nothing to do with the management or running of the business. Any cash she received from it could be attributed to reimbursing her for items she had purchased for it.

The judge added that he did not criticise HMRC for their contention that the taxpayer and V were partners. They had formed their case carefully, and acted reasonably throughout. Furthermore, had the taxpayer and V been prepared to discuss the matter at a meeting with HMRC, it might have helped clarify the situation.

The taxpayer's appeal was allowed.

Comments – This case demonstrates the importance of the facts in determining what the tax status of the taxpayer is – in this case the two parties had been trading in partnership but that business had ceased and although the same parties were involved in a similar business the FTT quite correctly examined exactly what the position was and made the correct determination.

Mrs P Valentine TC1644

Film rights: whether the LLP was trading

On 3 April 2007 the appellant, a limited liability partnership, obtained a 20-year licence from Disney to exploit and distribute two of their films in return for a licence fee of £503 million and also a variable royalty. The licence fee was divided into 20 annual instalments and on 3 April 2007 the appellant paid Disney the aggregate amount as an advance against its obligations to pay the annual instalments. At the same time the appellant entered into a sub-licence with the distributor to exploit and distribute the films for a 20 year period ("the distribution agreement"), under which the distributor paid, inter alia, annual ordinary distributions and contingent receipts. As security for its obligations to pay the annual ordinary distributions, the distributor provided a letter of credit ("the letter of credit") issued by the bank in order to secure its payment obligations. The distributor deposited £497 million with the bank and charged that sum to secure the issue of the letter of credit and fund the bank in respect of its obligations under the letter of credit, with the effect the bank was substituted for the distributor risk.

The appellant was financed by its 289 partners ("the members"), the majority of whom were individuals liable to UK income tax, who contributed a total £840 million capital payment to pay the licence advance to Disney. Each member chose to finance 94% of his capital contribution via a 20-year loan from the bank's subsidiary ("E"), which in turn was loaned the money by the bank; and the remainder came from the members' own resources. Under the terms of the loan with E, the members were required to pre-pay the interest accruing over the first ten years. The borrowing by members from E was secured by a charge given by the appellant over the letter of credit. Thereafter, and also on 3 April 2007, the appellant made a £293 million payment (expressed to be by way of loan on account of anticipated profits), under the partnership agreement, to the members, thereby enabling them to make the pre-payment of interest to E under their respective loan facility letters. In addition, the appellant entered into an agreement with W for the provision of marketing and advisory services ("the marketing services agreement") whereby W agreed, for a fixed fee plus a share of any contingent receipts from the films, to act as the appellant's agent in developing marketing and release plans for the films and to provide services relating to the supervision of the distributor in its implementations of such plans. The appellant also entered into a partnership consultancy agreement ("the consultancy agreement") with F to provide film advisory and other services.

The members claimed tax relief on the pre-payment under TA 1988 s 362(1)(b) on the basis that the appellant was carrying on a trade and that the borrowed money they contributed it by way of capital was used wholly for the purposes of that trade. In its partnership return for the year ended 5 April 2007 the appellant claimed that it was, in that year, carrying on a trade of acquiring and exploiting film rights, although no profits from that trade had accrued in that year, as evidenced through the marketing services and consultancy agreements. HMRC issued a decision that, in the tax year ended 5 April 2007, the appellant was not carrying on a trade; the venture was no more than an elaborate exercise of structured financial engineering built around a semblance of acquiring and sub-licencing film rights and all with a view to creating an interest charge for the members for which they could claim tax relief: as such the transactions should be considered as a composite whole. The appellant appealed contending, inter alia, the manner and extent to which the members financed themselves to provide capital was not relevant to the issue of whether it was carrying on a trade, nor were the banking and security arrangements. The issue arose as to whether (i) the appellant was carrying on a trade, or (ii) it was a non-trade business within the meaning of ITTOIA 2005 s 609.

Decision:

A purposive construction of the concept of "trade" as that word was used in the Corporation Tax Act had to take account of the definition in TA 1988 s 832(1) that it "includes every trade, manufacture, adventure or concern in the nature of trade". An element of speculation was a characteristic of the concept of trade – if a taxpayer was trading, what he did had to, normally at any rate, be speculative in the sense that he took a risk that the transaction(s) might not be as profitable as expected (or indeed gave rise to a loss). In the present case, the profit over a 20 year period, year by year, was determined at the outset, and was determined without any reference to the success or otherwise of the exploitation of the rights sub-licensed. In those circumstances it was not possible to realistically regard the profit as the speculative profit of a trading venture consisting of the exploitation of film rights. The risk of the bank not meeting its liabilities under the letter of credit was too remote to cause the pre-determined profit to be speculative in any relevant sense. In addition, and importantly, the risk was not associated with the acquisition and exploitation of the rights in the films; it was associated with the solvency of the bank, which was a factor as far removed from what the appellant did as the members' financing arrangements. Furthermore, the contingent receipts were the only element of the income streams which the appellant had bargained for which was affected by the performance of the films in consequence of their exploitation. The prospect of the appellant actually receiving any contingent receipts was highly speculative, and so remote as to make wholly unrealistic a conclusion that the entitlement to contingent receipts under the sub-licence of the rights in the films gave the sub-licence the character of a trading transaction. Accordingly the transactions entered into by the appellant did not have the speculative aspect to be reasonably expected to be seen in trading transactions.

In considering what the transactions offered to provide by way of business and if there was any discernible customer, it was difficult to see what services the appellant realistically offered to provide to the Disney group by way of business. The appellant did sub-license the rights to the distributor, but it had acquired the self-same rights a moment previously from Disney and had acquired them on terms whereby they would be so sub-licensed. The distributor was not the appellant's customer on any meaningful basis. On a realistic view of the facts, on any commercially meaningful basis, the appellant had no customer and did not offer to provide any goods or services by way of business. The acquisition and sub-licence of the rights by the appellant, although having legal effect according to their terms, could not be characterised realistically as the provision of services by the appellant to Disney by way of business. Those considerations plainly pointed to the conclusion that the appellant was not trading. Moreover, the licensing agreement and distribution agreement could not be regarded as trading transactions on the analogy of a sale and leaseback transaction. The appellant did not claim to be carrying on a financial trade and in any case did not provide finance. In addition, the trade of acquiring and exploiting film rights usually involved the retention by the trader of some residual film rights having commercial reality. Here the appellant effectively and realistically sub-licensed to the distributor everything it acquired from Disney.

In determining whether the appellant was carrying on a trade, it was necessary to consider the partnership consultancy agreement, the marketing services agreement, the licensing agreement with Disney and the distribution agreement. However, although the manner in and extent to which the members financed themselves to contribute the necessary and the banking and security arrangements entered into by the bank and were extraneous to whatever it was that the appellant did, those documents were relevant to the extent to which they were part of the context in which the appellant entered into the transactions identified. The members' financing arrangements and the banking and security arrangements affected the commerciality of what the appellant did with the consequence that the shape and character of the transaction was no longer that of a trading transaction. The appellant's paramount object was to obtain the returns inherent in the distribution agreement. What it actually did was not a trading transaction at all. But equally it could not be characterised as a mere device to secure a fiscal advantage.

The appellant could not rely on the legal effect of the agreements it entered into to show that it was conducting a trade. Viewed realistically its activities amounted to a business involving the exploitation of films which did not amount to a trade, ie a non-trade business within ITTOIA 2005 s 609(1).

Appeal dismissed.

Comments - There is a great deal of money at stake in this case. The First-tier Tribunal upheld HMRC's contention that the partnership was not carrying on a trade.

Eclipse Film Partners No 35 LLP v Revenue and Customs Comrs (No 2) TC 1963

Short-Life Assets (Lecture B716 – 10.47 minutes)

When claiming capital allowances on plant and machinery which are short-life assets (SLA), they can be pooled separately by election, so as to give rise to a balancing allowance on disposal or scrapping instead of simply deducting the proceeds from the general pool.

It is a particularly attractive option where the total capital expenditure on plant and machinery exceeds the AIA level.

The expected life to be a short-life asset increased from 4 years to 8 years from April 2011.

Where the expenditure exceeds the AIA it is therefore sensible to pool each asset separately as an SLA so as to obtain a full tax write-off on disposal or when the asset is scrapped. If the asset is still owned after the 8 year period it is then transferred to the general pool.

A single asset pool is created by making an election – within two years after the end of the accounting period of expenditure (companies) or within one year after the 31 January following the tax year in which the period of account ends (sole traders or partnerships).

IRSP 1/86 covers practical aspects of short-life asset pooling, including the grouping of classes of assets where individual treatment is impossible or impracticable.

Paragraph CA23640 of the *Capital Allowances Manual* also refers to practical aspects by stating that strictly an election for short life asset treatment should specify each asset it covers together with its cost but that if separate identification of the SLAs acquired in a chargeable period is impossible or impracticable, then HMRC should accept an election that gives information about the assets by reference to batches of acquisitions, with their costs aggregated and shown in one amount provided they are satisfied that:

- the assets are not specifically excluded, and
- the election gives enough information for it to be clear what is and what is not covered by it.

That paragraph also says that strictly each SLA should go into its own separate pool so that the allowances on it are calculated separately. This may not be practicable where assets are held in large numbers. In cases like that capital allowance computations that give the correct statutory result, and do not abuse the SLA provisions, should be accepted even if there is not a separate computation for each asset.

By making an SLA election the total capital allowances over the period of ownership of the asset increases, but the balance carried forward to the next year is reduced by the same amount. It therefore represents a cash flow benefit, which can be of a significant amount depending of course on the sums involved.

Illustration

- *General pool at start of period = £100,000*
- *Single item of equipment bought in Year 1 for £10,000 and sold in Year 3 for £1,000.*
- *Other assets bought in Year 1 up to AIA level of £25,000*

If no SLA election made:

Total capital allowances from above = £25,000 + £19,800 + £16,236 + £13,134
= £74,170 to end of Year 3

If SLA election made:

Total capital allowances from above = £25,000 +18,000 + £1,800 + £14,760 + £1,476 + £12,103 + £5,724

= £78,863 to end of Year 3. This is an increase of £78,863 - £74,170 = £4,693.

Contributed by Gerry Hart

Company providing rented housing: whether a charity

The taxpayer company was a registered social landlord. It was incorporated in 2001 and had adopted a memorandum of association and articles, under which the taxpayer's objects were stated as being the business of providing housing, accommodation, assistance to help house people, associated facilities and amenities, and any other objects that could be carried out by a company registered as a social landlord for the benefit of the community. The taxpayer was stated as trading not for profit. The taxpayer had also incorporated into its objects clause the activities permitted by s 2(4) of the Housing Act 1996 (the 1996 Act). However, at that time the taxpayer had set out to be a registered charity as provided under s 2(1)(a) of the 1996 Act. In 2004, the taxpayer changed its memorandum and articles and was registered as a charity. However, the Revenue and Customs Commissioners determined that between 2001 and 2004 (the relevant period) the taxpayer had not been acting for charitable purposes for corporation tax purposes. The taxpayer challenged that determination. The First-tier Tribunal (Tax and Chancery Chamber), with which the Upper Tribunal (Tax and Chancery Chamber) (the Upper Tribunal) agreed, held that the taxpayer's principal activity was intended to have been, and had in fact been, the acquisition of housing stock from the local authority, its refurbishment and its letting to tenants. Further, the Upper Tribunal held that the key point had been that the taxpayer had been able, had it chosen, to pursue any of the permissible objects or purposes set out in s 2(4) of the 1996 Act without reference to its then current activities. On that basis the Upper Tribunal found that the taxpayer had not been acting for charitable purposes during the relevant period. The taxpayer appealed.

The taxpayer submitted, first, that the range of activities which could be undertaken under the objects clause was constrained by the requirement that whatever the taxpayer did had to have been done for the benefit of the community, and that, on that basis, the operations open to it were of a kind that were limited to that which was charitable. Secondly, the provision, maintenance and management of a stock of housing, and in particular one which was of good quality, available for occupation by tenants, was in itself of general public utility, and for the benefit of the community, and that the court could proceed by analogy from the various types of public works mentioned in the preamble to the Statute of Charities Act 1601 (the preamble) which had provided benefits to the public generally in a given area, though also providing particular benefits to individuals. Consideration was given to Williams' Trustees v IRC([1947] 1 All ER 513) (Williams' Trustees), and Incorporated Council of Law Reporting for England and Wales v A-G([1971] 3 All ER 1029) (ICLR).

Decision:

The appeal would be dismissed.

(1) On their true construction, the objects of the claimant had not been limited to undertaking operations which were for the primary benefit of the community, to the exclusion of non-incidental benefit for

individuals. That was because of the incorporation into the objects clause of the activities permitted by s 2(4) of the 1996 Act, in particular those listed at para (b), (d), (e) (as regards owners) and (f) of s 2(4) of the 1996 Act.

(2) With regard to the development of the law, in particular ICLR and Williams' Trustees, the provision of a housing stock available for occupation by tenants generally (rather than so as to relieve a charitable need) was not a charitable purpose, because it could only be so if it had come within the category of 'other purposes beneficial to the community', and it did not do that because it was not within the spirit and intendment of the preamble, nor was it analogous with the examples in the preamble of works of general public utility. Furthermore, the degree of individual benefit afforded by the provision of housing was so substantial that it could not properly be regarded as subordinate to the public benefit of the availability of a stock of suitable housing.

It was not sufficient that the operations of the claimant should be required to be for the benefit of the community. They could qualify as such without being charitable. In order to be charitable the benefit provided had to be of an appropriate kind, and in the instant case, it was not.

Income Tax Special Purposes Comrs v Pemsel [1891-4] All ER Rep 28 applied; Williams' Trustees v IRC [1947] 1 All ER 513 explained; Incorporated Council of Law Reporting for England and Wales v A-G [1971] 3 All ER 1029 explained; IRC v Baddeley [1955] 1 All ER 525 considered; IRC v Oldham Training and Enterprise Council [1996] STC 1218 considered; Independent Schools Council v Charity Commission for England and Wales; A-G v Charity Commission for England and Wales [2012] 1 All ER 127 considered.

Decision of the upper tribunal (Tax and Chancery chamber) [2011] All ER (D) 206 (Apr) affirmed.

Comments - The CA unanimously upheld HMRC's view that from 2001 to 2004 the company failed to qualify as a charity. Lloyd LJ's judgment includes an extensive review of the previous case law, and is worth reading in full.

Helena Partnerships Ltd (aka Helena Housing Ltd) v HMRC [2012] EWCA Civ 569

Extent of warranties

The claimant company entered into a sale and purchase agreement (SPA) with the defendant company, under which the defendant purchased the entire issued share capital in two companies. The result of the SPA was that the defendant acquired a number of subsidiary companies (the sold companies), including companies which then changed names to Brightsea (EOL) Ltd and Mulgate Investments Ltd (Mulgate). All of the acquired companies had formed part of a group, of which the claimant was the parent, but the sale had not included all the companies within the group. A number of companies had been retained by the claimant, including a company called Astra House Ltd (Astra). The sold companies were transferred at their net asset value (NAV), the consideration being valued by reference to a consolidated balance sheet, which had included provision for liability to corporation tax.

The SPA had contained detailed provisions governing the preparation of the consolidated balance sheet, including calculation of corporation tax. The claimant had also given warranties in the SPA regarding the tax position of the sold companies, which had included, inter alia, a warranty that the sold companies had been under no obligation to make, nor had they been entitled to recover, any payment for group relief other than as disclosed in the consolidated balance sheet. It had also been a term of the SPA that the parties would on completion execute a tax deed, which had contained certain covenants and guarantees relating to tax matters. In the tax year ending March 2006, Brightsea (EOL) Ltd had suffered losses, which had already been allocated between various sold and retained companies to obtain group relief against corporation tax.

A proportion of the losses had been allocated to Mulgate, and a smaller sum to Astra. It had been identified that Mulgate had been due to receive a repayment of corporation tax for the following tax period, and that repayment had not been taken into account in the consolidated balance sheet. The repayment had been intended to correct an earlier overpayment of tax by Mulgate, but it had not been taken into account in calculating the NAV of the sold companies in the consolidated balance sheet. It had also been identified that there had been a group-wide overprovision for corporation tax in the consolidated balance sheet. The tax deed had contained no provision whereby the claimant could recover such overprovision directly from the defendant.

Accordingly, the claimant proceeded to use powers contained within the tax deed to direct the defendant to procure the signature on behalf of Brightsea (EOL) Ltd and Mulgate on two tax forms electing to adjust the surrenders of group relief previously made in respect of Brightsea (EOL) Ltd's losses. Effectively, the claimant had required the tax relief to be moved from Mulgate to Astra. The claimant issued proceedings seeking a declaration that it had been entitled to require the defendant to execute the required tax forms.

The judge held that the provisions of the tax deed had permitted the claimant to require a re-adjustment in the surrender of group relief by Brightsea (EOL) Ltd even though the purpose of the relevant provisions of the Tax Deed had ultimately been to recoup the overprovision for corporation tax in the consolidated balance sheet. The judge accordingly granted a declaration that the claimant had been entitled to give a direction and that the defendant and Mulgate had been obliged to comply with it. He ordered the defendant to deliver the tax forms to the claimant but stayed his order pending an application by the defendant for permission to appeal. The defendant appealed, but, notwithstanding the stay, had delivered the executed tax forms to the claimant. As a consequence, the Revenue and Customs Commissioners assessed Mulgate's additional corporation tax.

The defendant submitted that the provisions of the tax deed had to be given a meaning and effect that was consistent with the allocation of benefits and liabilities of the sold companies in the pre-completion periods, to the effect that the amount of any unforeseen tax liabilities arising from pre-completion profits, or which were due to reliefs taken into account in the consolidated balance sheet not being available, had had to be paid by the claimant to the defendant as the consolidated balance sheet calculations of liabilities had remained the contractual yardstick by which the additional tax liability had fallen to be measured. The defendant further contended that if the appeal were to be allowed, then the court should go further than merely granting a declaration that the claimant had not been entitled to require the defendant to execute the tax forms, since by complying with the judge's order, albeit whilst the stay had been in place, the defendant had suffered a detrimental effect in terms of tax consequences. The defendant accordingly contended that an order should be made to reflect the consequences that had flowed from the judge's order.

Decision:

The appeal would be allowed.

1st Ground

The SPA had contained no provisions for the adjustment of the consideration to take account of subsequent changes in the tax position of the sold companies. Instead, the SPA had delegated the treatment of those matters to the tax deed, which had been entered into as a condition of the sale. The tax deed had set out to deal with, inter alia, unexpected tax liabilities adverse to the sold companies arising in respect of the pre-completion tax periods, and the conduct and completion of the tax affairs of the sold companies for any pre-completion tax periods. The terms of the Tax Deed had been intended to prevent the power of the claimant to direct the defendant to procure the relevant tax forms being used to change the allocation of liabilities and the use of reliefs as set out in the main body of the tax deed.

That had been the only restriction on the otherwise extensive powers of the claimant to re-arrange, for example the allocation of group relief which underpinned the provision for taxation in the consolidated balance sheet, accordingly the provisions of the tax deed had been intended to have and had had to be given a meaning which best accorded with the ascertainable objectives of that deed. The provisions of the tax deed largely respected the calculation of NAV contained in the consolidated balance sheet. The indemnity contained in the tax deed, therefore, had operated to protect the defendant as purchaser from additional tax liabilities imposed on the sold companies by the non-availability of reliefs that had been factored into the consolidated balance sheet calculations. However, the liability of the claimant had been mitigated by any failure on the part of the sold companies to use other available reliefs. The powers conferred in the tax deed were primarily concerned with the completion of the tax affairs of the sold companies for the pre-completion periods at a time when they had ceased to be under the claimant's control. It would have been expected, therefore, that those provisions would have protected the claimant against any re-organisation of, or failure to complete, its tax affairs for those years which might have created additional liabilities for the claimant. None of the provisions of the tax deed suggested that they were to be read as intending to give effect to a significant change in the financial consequences of the transaction for either party. The claimant had not therefore been entitled to make the direction to the defendant.

The judge had been wrong in his construction of the tax deed.

2nd Ground

As a general rule, a party who had acted in pursuance of a court order would not become liable in damages for those acts even if it had subsequently transpired on appeal that the original order should never have been made.

There would therefore be obvious obstacles in the way of any action by the defendant to recover the lost relief insofar as its cause of action was based on compliance with the judge's order. If the defendant's compliance was the result of the court order for specific performance, for example, then the defendant would not be denied the benefit of an order upon appeal reversing the effect of the order. There was no reason in principle why that should not extend to requiring the unsuccessful respondent to disgorge the financial benefits directly obtained as a result of the original order. The effects of the judge's order had been to allow the defendant to effect a re-allocation of the group relief from Mulgate to Astra. The financial consequences had been direct, readily identifiable and easily calculable. The court had jurisdiction to make an order for repayment if the process could not be unwound just as much as it would be able to order the re-conveyance of property in the event of a reversal of an order for specific performance.

An order was accordingly made to that effect.

Comments - This case demonstrates the importance when advising in relation to the tax affairs of a group and also to a sale and purchase agreement that the terms and details are properly and clearly set out so that they can be properly understood and executed. This is particularly true when dealing with affairs post April 2010 when time limits for actions and solutions has become less with the general limit of 4 years.

Drachs Investments No 3 Ltd v Brightsea UK Ltd [2012] EWCA Civ 516

Underdeclared profits: HMRC imposing penalty

A married couple controlled a small engineering company: the husband was the managing director while his wife was the company secretary. HMRC formed the opinion that the company had underdeclared profits which the couple had extracted from the business. They issued assessments and imposed penalties at the rate of 15% of the evaded tax. The company appealed.

Decision:

The First-tier Tribunal reviewed the evidence in detail and dismissed the appeal. Judge King observed that 'it is clear from the cases that a default by directors can and should be assessed to tax in a company.'

Comments - Where a company has underdeclared takings which appear to have been extracted by its directors, HMRC will normally issue assessments under CTA 2010 s 455, and will also impose penalties. The decision here is in line with previous cases such as Khera's Emporium Ltd v Marshall ([1998] STC (SCD) 206), Cooksey v HMRC (TC00221) and Powerlaunch Ltd v HMRC (TC01426).

TSD Design Development Engineering Ltd v HMRC TC1941

Research & Development – What projects qualify? **(Lecture B718 – 15.14 minutes)**

Section 837A Income and Corporation Taxes Act 1988, which is rewritten to section 1006 Income Tax Act 2007 and section 1138 Corporation Tax Act 2010, define R&D for tax purposes. It states that R&D means activities that fall to be treated as R&D in accordance with generally accepted accounting practice.

The Statement of Standard Accounting Practice 13 “Accounting for Research and Development” defines R&D which is then modified for tax purposes by the “Guidelines on the Meaning of Research and Development for Tax Purposes” (Guidelines) issued by the Secretary of State for Trade and Industry (now the Department for Business, Innovation and Skills) on 5 March 2004.

<u>R&D definition</u>

A project needs to seek to achieve an advance in science or technology for it to qualify as R&D for tax purposes. All branches and fields of science and technology are included thus there is no difference whether an advance is achieved in the textile industry or nanotechnology.

R&D begins when work to resolve a scientific or technological uncertainty starts and ends when the uncertainty is resolved or work to resolve it ceases. If R&D has ended but there appear to be problems that need extra activities it is necessary to distinguish new R&D and fault fixing.

<u>Direct and indirect activities</u>

Only direct and qualifying indirect activities that contribute to the resolution of scientific or technological uncertainty comprise R&D. For example, work to raise finance for a project; although it is indirectly contributing to the resolution of scientific and technological uncertainty does not of itself help to resolve the uncertainty and thus is not R&D. Human Resources work supports R&D and is qualifying indirect activity thus qualifying as R&D.

Activities which directly contribute to R&D include:

- activities to create or adapt software, materials or equipment needed to resolve the scientific or technological uncertainty, provided that the software, material or equipment is created or adapted solely for use in R&D;
- scientific or technological planning activities; and
- scientific or technological design, testing and analysis undertaken to resolve the scientific or technological uncertainty.

Activities which do not directly contribute to the resolution of scientific or technological uncertainty include:

- the range of commercial and financial steps necessary for innovation and for the successful development and marketing of a new or appreciably improved process, material, device, product or service;
- work to develop non-scientific or non-technological aspects of a new or appreciably improved process, material, device, product or service;
- the production and distribution of goods and services;
- administration and other supporting services;
- general support services (such as transportation, storage, cleaning, repair, maintenance and security); and
- qualifying indirect activities.

Qualifying indirect activities:

- scientific and technical information services, insofar as they are conducted for the purpose of R&D support (such as the preparation of the original report of R&D findings);
- indirect supporting activities such as maintenance, security, administration and clerical activities, and finance and personnel activities, insofar as undertaken for R&D;
- ancillary activities essential to the undertaking of R&D (e.g. taking on and paying staff, leasing laboratories and maintaining research and development equipment including computers used for R&D purposes);
- training required to directly support an R&D project;
- research by students and researchers carried out at universities;
- research (including related data collection) to devise new scientific or technological testing, survey, or sampling methods, where this research is not R&D in its own right; and
- feasibility studies to inform the strategic direction of a specific R&D activity.

Planning activities need to directly contribute to resolving an uncertainty to be R&D. Market research to identify whether R&D might benefit the company or analysing legal, marketing and financial aspects do not directly contribute to the resolution of a scientific or technological uncertainty. For example, if a company conducts market research to find out which technical and design characteristics a new camera should have in order to be popular, then this is not R&D work.

<u>Achieving an advance</u>

By achieving an advance it is meant an advance in overall knowledge or capability in science or technology not just within a company alone. An advance can mean having tangible or intangible outcomes. Merely the fact that science or technology is used in the process of creating something does not make it an advance in science or technology.

The main characteristics of a project qualifying as R&D according to the Guidelines:

- Seeks to extend overall knowledge or capability in science or technology; or
- Seeks to create a process, material, device, product or service which incorporates or represents an increase in overall knowledge or capability in a field of science or technology; or
- Seeks to make an appreciable improvement to an existing process, material, device, product or service through scientific or technological changes; or
- Seeks to use science or technology to duplicate the effect of an existing process, material, device, product or service in a new or appreciably improved way (e.g. a product which has exactly the same performance characteristics as existing models, but is built in a fundamentally different manner).

Even if a project does not succeed, it qualifies for R&D if the initial intention was to achieve advance. In situations where scientific or technological planning activities have occurred but the project is not taken forward due to challenges, the activities still qualify as R&D. Also in situations where an advance has been already achieved but the details have not been made public, the project or work done can qualify as an advance in science or technology. It is the same in cases where it is publicly known that the advance has already been achieved but the specifics of how are not readily available. Even a number of companies doing work in the same field but independently can achieve advance in overall knowledge or capability and thus be R&D work. The routine analysis, copying or adaptation of something already existing will not be an advance.

Scientific or technological uncertainty

For a scientific or technological uncertainty to exist, the knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, must not be readily available or deducible by a competent professional working in the field. It is stated in the Guidelines that system uncertainty is included. System uncertainty can be either scientific or technological uncertainty but it results from the complexity of the system rather than how individual components act.

In order to create uncertainty one must turn something that has already been established as scientifically feasible into a cost-effective, reliable and reproducible process, material, device, product or service. If a competent professional working in the field can readily resolve an uncertainty then this is not a scientific or technological uncertainty. Likewise, all activities which do not materially affect the underlying science or technology do not comprise as work done to resolve scientific or technological uncertainties.

Contributed by Paul Howard, Gabelle LLP

Supreme Court Judgment in FII Group Litigation Order case

The Appellants are all companies which belong to groups which have UK-resident parents and also have foreign subsidiaries, both in the European Union and elsewhere. The purpose of the litigation was to determine various questions of law arising from the tax treatment of dividends received by UK-resident companies from non-resident subsidiaries, as compared with the treatment of dividends received from subsidiaries within wholly UK-resident groups of companies. The provisions giving rise to these questions related to the system of advance corporation tax ('ACT') and to the taxation of dividend income from non-resident sources under section 18 (Schedule D, Case V) of the Income and Corporation Taxes Act 1988 ('ICTA'). The relevant provisions have since been amended or repealed, but the problems created by their existence in the past have not gone away.

The Appellants' case is that the differences between their tax treatment and that of wholly UK-resident groups of companies breached article 43 (freedom of establishment) and article 56 (free movement of capital) of the EC Treaty, and that these breaches have caused them considerable loss.

A previous reference to the Court of Justice of the European Union ('CJEU') held that those principles had, at least in some respects, been breached. The issues in this appeal to the Supreme Court relate to the requirements under both EU and domestic law as to the availability of remedies for such breaches of EU law.

It is common ground that two types of restitutionary remedies are available in domestic law in this situation: a claim for restitution of tax unlawfully demanded (under the 'Woolwich' principle), and a claim for tax wrongly paid under a mistake (a 'DMG' claim). EU law requires there to be an effective remedy for monies paid in respect of tax that has been unlawfully charged. In the present case, the Woolwich cause of action was now time-barred. The limitation period for DMG mistake claims had been extended by section 32(1)(c) of the Limitation Act 1980 ('LA'). However, in June 2004, s320 of the Finance Act 2004 was enacted, retrospectively excluding the application of s32(1)(c) in relation to claims based on a mistake of law relating to a taxation matter, where the action was brought on or after 8 September 2003. In July 2007, s107 of the Finance Act 2007 came into force. It excluded the application of s32(1)(c) to any DMG claims brought before 8 September 2003.

The Court of Appeal held: that the Woolwich restitution remedy was a sufficient remedy as EU law does not require that there must always be a remedy based on mistake; that the Woolwich restitution remedy met the requirements of EU law and was not affected by sections 320 and 107; that the restitution and damages remedies sought by the Appellants in respect of one part of the claim were excluded by virtue of the statutory provisions for recovery of overpaid tax in section 33 of the Taxes Management Act 1970; and that section 32(1)(c) of the Limitation Act 1980 could be given a wider meaning so as to apply to a Woolwich claim.

The Appeal raises the following specific issues:

(1) Could Parliament lawfully curtail without notice the extended limitation period under section 32(1)(c) of the Limitation Act 1980 for the mistake cause of action (section 320 FA 2004) and cancel claims made using that cause of action for the extended period (section 107 FA 2007)? In particular:

(a) Would a Woolwich restitution remedy be a sufficient remedy for the repayment claims brought on the basis of EU law?

(b) Whether or not a Woolwich restitution remedy would be a sufficient remedy, does EU law protect the claims which were made in mistake; and, specifically, did the curtailment without notice of the extended limitation period for mistake claims (section 320 FA 2004) and the cancellation of such claims in respect of the extended period (section 107 FA 2007) infringe the EU law principles of effectiveness, legal certainty, legitimate expectations and rule of law?

(2) Are the restitution and damages remedies sought by the Appellants in respect of corporation tax paid under section 18 of the ICTA excluded by virtue of the statutory provisions for recovery of overpaid tax in section 33 of the Taxes Management Act 1970?

(3) Does section 32(1)(c) of the Limitation Act 1980 apply to a claim for a Woolwich restitution remedy?

(4) Does the Woolwich restitution remedy apply only to tax that is demanded by the Revenue, and not to tax such as ACT which is payable on a return; and, if so, what amounts to a demand?

Decision:

The Supreme Court unanimously dismisses the appeal on issues (3) and (4), and allows the appeal on issue (2). On issue (1), a reference is made to the CJEU for a preliminary ruling under article 267 Treaty on the Functioning of the European Union.

Issue (1)

The central question in the appeal is whether EU law requires only that the member state must make available an adequate remedy which meets the principles of effectiveness and equivalence, or whether it requires every remedy recognised in domestic law to be available so that the taxpayer may obtain the benefit of any special advantages that this may offer on the question of limitation [13, 38]. The majority of the Court (Lord Sumption and Lord Brown dissenting [123 & 142]) holds that the Woolwich remedy on its own was not sufficient to meet the requirements of effectiveness and equivalence; an effective remedy was also required in the DMG mistake cause of action. The principle of equivalence requires that the rules regulating the right to recover taxes levied in breach of EU law must be no less favourable than those governing similar domestic actions. It must follow, if the means of recovering of taxes levied contrary to EU law are to match those in domestic law, that both remedies should be available [21, 212]. The retrospective application of the section 320 FA 2004 limitation period was therefore not compatible with EU law as it infringed the principles of equivalence and effectiveness, and possibly also the principle of legitimate expectations .

In relation to s107 FA 2007, the Court unanimously holds that, by 2006, the Appellants had acquired a legitimate expectation that their entitlement to have their DMG claims decided by a court would not be removed from them by the introduction without notice of a limitation period that was not fixed in advance. So it was not lawful for Parliament to cancel claims made using the mistake cause of action for the extended period.

Since the Court is divided on the question as to whether EU law requires that both remedies should be available to the Appellants so that they can choose the remedy that best suits their case for reimbursement, the matter is not acte clair. A reference to the CJEU is necessary.

Issue (2)

The question is answered in the negative. Section 33 can be given an interpretation in conformity with EU law by not construing it as impliedly setting itself up as an exclusive provision. The common law claim in unjust enrichment remains available. The appeal on this issue is allowed.

Issue (3)

The question is answered in the negative. The extension to the limitation period under section 32(1)(c) should not be read widely so as to apply to Woolwich claims. The Court should not seek to develop the law by broadening the interpretation of 'an action for relief from the consequences of a mistake' [62, 186]. The appeal on this issue is dismissed.

Issue (4)

The question is answered in the negative. The Woolwich restitution remedy is not limited to tax that is demanded by the Revenue, but is available to cover all sums paid to a public authority in response to (and sufficiently causally connected with) an apparent statutory requirement to pay tax which (in fact and in law) is not lawfully due [79, 174]. The appeal on this issue also is dismissed.

Comments - The Supreme Court has overturned by a majority parts of the Court of Appeal's judgment in the Test Claimants in the FII Group Litigation case, concerning the limitation period on corporation tax repayment claims by a group of litigants headed by BAT. The Supreme Court decided that remedies made available by the UK government are not sufficient to comply with EU law and has made a further reference to the ECJ.

Test Claimants in the Franked Investment Income Group Litigation (Appellants) v Commissioners of Inland Revenue and another (Respondents) [2012] UKSC 19

No discrimination

The appeal related to the averaging of farming profits. In the year 2005/06, the taxpayer, a farmer and agricultural contractor, had a trading profit from his farming business of £20,244. In 2006/07, he suffered a loss of £10,315. This was partly because he sold farm machinery towards the end of 2005, and bought replacement machinery after April 2006. He sought to apply averaging under ITTOIA 2005, s 221 to the 2005/06 profit and the 2007/08 loss.

HMRC said the calculation was incorrect as averaging only applies to profits. This led to the taxpayer having taxable profits for both years, with a trading loss in 2006/07 which could be set against the profit for that year (as averaged), leaving a small loss to be carried forward to 2007/08.

The First-tier Tribunal dismissed the taxpayer's appeal, so he appealed to the Upper Tribunal.

The taxpayer accepted HMRC's calculations were correct, but argued that the effect of the legislation was discriminatory and breached his human rights.

Decision:

The Upper Tribunal described this as 'a hopeless argument'. Farmers are under no obligation to claim averaging: the provision gives farmers (and those whose profits are derived from creative works) a benefit not available to other business taxpayers. If anything, it discriminates in favour of farmers.

The taxpayer accepted that he is better off as a result of claiming averaging, but said the measure did not go far enough to compensate him from the effects of extreme fluctuations in profits. Losses should be included in the averaging calculation as negative profits, to offer relief to farmers who suffer from extreme swings from profit into loss.

The Upper Tribunal concluded that the First-tier Tribunal reached the right decision for the right reasons. The taxpayer's appeal was dismissed.

Comments - ITTOIA 2005 s 221 provides that farmers (and creative artists) may submit claims for their profits to be averaged. The Upper Tribunal upheld HMRC's interpretation of this provision, and rejected the farmer's contention that it was discriminatory.

Donaghy v CRC, Upper Tribunal (Tax and Chancery Chamber), 11 May 2012

VAT

Single purpose face value vouchers

A new clause is being introduced in Finance Bill 2012 to amend VATA 1994, Sch 10A so that, in the case of single purpose vouchers, VAT will be due when they are first issued. Although the legislation will apply from 10 May 2012, any VAT due arising from its operation will not become payable until after FA 2012 receives Royal Assent. The government is making this change in response to the recent ECJ decision in Lebara Ltd.

A single purpose face value voucher is one that carries the right to receive only one type of goods or services which are all subject to a single rate of VAT. These may include, but are not restricted to, pre-paid telephone cards, electronic downloads vouchers and vouchers for a specific service (such as group purchase vouchers). There is no change to the treatment of face value vouchers that can be used to buy more than one type of good or service.

Schedule 10A to the VAT Act 1994 provides that the consideration for the sale of a face value voucher is disregarded and VAT becomes due only when it is redeemed for supplies of goods or services.

VAT on single purpose face value vouchers will now become due, if applicable, when they are issued rather than when they are used to purchase goods or services. Tax will also be due on each subsequent sale of the voucher, subject to the usual rules on liability and place of supply.

Input tax on exempt supplies not deductible

A registered charity which organised a flower show reclaimed input tax. HMRC rejected the claim on the basis that the flower show was an exempt supply within VATA 1994 Sch 9 Group 12 Item 1. The charity appealed, contending that it should be permitted to reclaim input tax because it had opted to tax the relevant land.

Decision:

The First-tier Tribunal dismissed the charity's appeal. Judge Cannan observed that 'the option to tax does not exclude exemption by virtue of Group 12' and that 'the Group 12 exemption is generally to the advantage of charities.'

Comments - Input tax is not recoverable where it is directly attributable to exempt supplies. The charity contended that it should be permitted to reclaim the relevant input tax because it had opted to tax the land from which the supplies would be made. Not surprisingly, the First-tier Tribunal rejected this contention. Judge Cannan's comments are self-explanatory.

Southport Flower Show Ltd v HMRC TC1938

Over-paying and under-declaring is not correct

When submitting his quarterly VAT returns, the taxpayer deliberately paid more VAT than was due to avoid the risk of underpayment. His accountant carried out a reconciliation at the end of the year and adjustments were made in subsequent returns to reflect the correct figures.

By 1 March 2006, he was in credit for overpaid VAT of £5,648.83. He decided to reclaim the amount by underdeclaring the VAT in the returns submitted after that date. During a VAT inspection in early 2010, HMRC said that the adjustments were unauthorised and only over or underpayments that were 'discovered' by the taxable person could be corrected via the VAT return. A deliberate error could not be discovered.

Decision:

The First-tier Tribunal noted that the taxpayer had 'knowingly submitted false VAT returns', and had signed the declaration on the returns saying that they were 'true and complete', when he knew they were not. Manipulating the VAT figures to manage cashflow had no basis in law, and deliberate errors could not be corrected by means of a voluntary disclosure.

The taxpayer's appeal was dismissed.

Comments - The key point with this case, said independent VAT consultant Neil Warren, is 'that deliberate under or overpayments of VAT on past returns cannot be treated as errors and corrected on a future VAT return if the amounts involved are less than the error notification limits (£10,000 for a small business and potentially a maximum of £50,000 for a large business). It is only errors that are discovered after the returns have been submitted that can be adjusted on a future return. A deliberate under or overpayment cannot be discovered at a future date if the taxpayer had knowledge of it when he submitted his original return. The only route to notify HMRC of the deliberate actions on previous returns is by submitting form VAT652'.

Hung On Chan TC1850

Wrong entity

In 2007, having been made redundant, the F set up a freelance courier service which he called Alba Express. He did not register for VAT. He bought two vans for the business.

In mid 2010, F incorporated the business, which he called S F Express Courier Ltd, and registered it for VAT. Later that year, as a result of calls to HMRC's national advice service, F claimed the VAT which he had paid on the purchase of the two vans. HMRC refused the claims.

Decision:

The First-tier Tribunal said that it was clear from reg 111 of the VAT Regulations 1995, that the taxpayer company was not entitled to recover the input tax, as only tax incurred by the taxable entity could be refunded. The vans had been supplied to Alba Express, which was never registered for VAT, rather than to the incorporated company, S F Express Courier Ltd. The taxpayer company's appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, said 'a key sentence in the regulations is that an input tax claim by a body under the pre-registration input tax rules can only be made if the goods or services in question have only been used "for the purpose of a business to be carried on by the body and has not used them for any purpose other than such a business". In the case of the two vans, they had clearly enjoyed another purpose, i.e. use by a separate business between 2008 and 2010.

He added that a limited company could 'claim input tax on its first VAT return in relation to certain expenses incurred before it was incorporated, but the claim must relate to goods bought within the four years before VAT registration and six months for services — the goods must be still held by the company on its date of VAT registration. A condition of a claim for pre-incorporation expenses is that the expenses in question must have been purchased by an officer of the company, and the company must fully reimburse him or her for these expenses, either through a bank or cash payment or director's loan account entry'.

S F Express Courier Ltd (TC1809)

Not subject to UK VAT

The taxpayer was a self-employed carpenter and joiner. He was not registered for VAT. HMRC said that the taxpayer should have registered for VAT in September 2006. The taxpayer's accountant wrote to HMRC advising that the taxpayer had carried out work in the Republic of Ireland in 2006 and 2007, and these jobs were outside the scope of UK VAT. Therefore he did not need to register. Copies of the relevant invoices were sent to HMRC.

HMRC said that the invoices did not show sufficient details of the work done, and in the absence of adequate documentation to show that work had been done in the Republic of Ireland, the place of supply would be treated as the UK.

The matter proceeded to the First-tier Tribunal.

Decision:

The tribunal decided that the taxpayer had provided sufficient evidence to show he had worked in the Republic of Ireland. The judge said he could 'not think what further evidence the appellant could have provided' to show the location of services he supplied. There was no evidence to show that the work had been carried out in the UK. On that basis, and on the balance of probabilities, the tribunal found that the services were provided in the Irish Republic and were outside the scope of UK VAT.

The taxpayer did not need to have registered for VAT and his appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said 'HMRC scored a bit of an own goal in this case by commenting about the absence of postcodes on sales invoices raised to the customers in Dublin — apparently, there are no postcodes in Ireland outside of Dublin'. He added that 'the case highlights that if taxpayers are prepared to challenge HMRC's analysis of a situation, then it can produce results at a tribunal'.

R Carville TC1600

LVCR is lawful

The case concerned the import of goods by mail order from the Channel Islands.

In November 2011, the Chancellor of the Exchequer announced that low value consignment relief (LVCR) would be withdrawn for all goods imported on or after 1 April 2012 from the Channel Islands.

A draft clause to be included in the Finance Bill 2012 amending the VAT (Imported Goods) Relief Order 1984, SI 1984/746 would ensure that the exemption did not apply to goods sent from the Channel Islands under a distance selling arrangement. The claimants applied for judicial review of the decision to disapply LVCR on a selective basis.

The court ruled that there was no principle of EU law which required the UK to treat the importation of low value goods on mail order from the Channel Islands in the same manner as similar goods from any other non-EU territory.

The draft clause was therefore not unlawful under EU law.

R (on the application of Minister for Economic Development of the States of Guernsey) v CRC and another case, Queen's Bench Division, 15 March 2012

Penalty for failure to charge VAT

A plumber (P) registered for VAT in 2006, but subsequently failed to charge VAT on his supplies. When HMRC discovered this, they imposed a penalty under FA 2007 Sch 24, at the rate of 20% of the potential lost revenue. P appealed, contending that his turnover had fallen below the threshold and his accountant had told him that he did not need to charge VAT.

Decision:

The tribunal dismissed his appeal, finding that P had been 'appallingly let down' by his accountant but that he had acted 'without reasonable care' and that the amount of the penalty was 'fair and reasonable'.

Comments - The First-tier Tribunal accepted the appellant's evidence that his accountant had told him that he did not need to account for VAT if his turnover had fallen below the threshold, even though he remained registered. Not surprisingly, the Tribunal held that since the appellant remained registered, he was still required to account for VAT, and also upheld a penalty at the rate of 20% of the potential lost revenue.

DA Perks v HMRC TC1930

Principles of Set off

In 2007, a bank appointed an administrative receiver over a company pursuant to the terms of a debenture. In January 2008, the receiver assigned the claimant company the benefit of an appeal against the disallowance of VAT input tax claimed by the company. In August 2010, the First-tier Tribunal (Tax and Chancery Chamber) (the FTT) pursuant to its decision on the appeal ordered the respondent Revenue and Customs Commissioners (the Revenue) to credit the claimant with VAT input tax in the disallowed sum.

In October 2010, the Revenue informed the claimant that it intended to set-off against the sum to which the claimant was entitled under the FTT decision, sums that it contended were owed to it by the company in respect of various historic taxes, including corporation tax and PAYE contributions. The claimant commenced proceedings for judicial review of the Revenue's decision to set-off on the ground that the set-off was unlawful.

In July 2011, it was ordered to be tried whether the Revenue could exercise a set-off and, if so, whether any sum payable pursuant to the assignment was payable subject to the set-off. In December 2011, the proceedings were transferred to the Chancery Division and it was further ordered to be tried whether the claimant was entitled to interest on the sum found due to it pursuant to the FTT decision. The instant proceedings concerned the hearing of those issues.

It fell to be determined:

(i) whether the Revenue was entitled to statutory set-off;

(ii) whether the Revenue was entitled to equitable set-off;

(iii) whether the claimant had had a legitimate expectation that the sums would not be set-off based on the Revenue's publicly stated position that set-off would only be applied if the taxpayer consented; and

(iv) whether the claimant was entitled to interest. Consideration was given to ss 130 to 133 of the Finance Act 2008 (the 2008 Act) and s 27 of the Tribunal, Courts and Enforcement Act 2007 (the 2007 Act).

The court ruled:

i. In respect of assignees, s 133 was clearly intended to impose a set-off on an assignee where no such set-off had been permissible prior to its enactment.

   In the instant case, there had been no general statutory right to set-off sums owed to the Revenue against sums owed by the Revenue to the company. The position was a fortiori in the case of an assignee, such as the claimant. That conclusion was consistent both with ss 130(8) and 133 of the 2008 Act.

ii. The general, established, principle was that set-off was founded in simple convenience and fairness. It should be taken to apply generally to all liquidated cross-claims unless excluded by statute or contract. Further, the test for equitable set-off required that cross-claims were so closely connected with the claimant's demands that it would be manifestly unjust to allow the claimant to enforce the payment without taking into account the cross-claim.

   In the instant case, it was difficult to conclude that the liability to pay VAT and the right to receive repayment in respect of corporation tax were so closely connected as to bring into existence a right corresponding to the equitable right of set-off in closely connected contracts. Furthermore, it was not manifestly unjust to deny the right of equitable set-off in such circumstances. As an assignee, the claimant took subject to the equities. However, as the Revenue had no right of set-off against the company, there could not be a right of set-off against the claimant. That conclusion became a fortiori when it was recalled that Parliament had, since the date of the assignment, specifically enacted provisions for set-off both as between taxpayers and the Revenue and between assignees and the Revenue.

   Accordingly, the Revenue's claim to set-off the sum owed to it by the company in respect of corporation tax and PAYE against the claimant's right as assignee to repayment of the VAT input tax would be dismissed.

iii. In the instant case, the statements in the consultation documents did not give rise to a legitimate expectation in the sense contended for by the claimant.

   Accordingly, the claimant's position that it had had a legitimate expectation that the Revenue would continue to apply the practice that it had applied prior to the date upon which it had taken the assignment was dismissed.

iv. Simply because a sum was recoverable as if it were payable under the order of the court did not make a judgment: it merely stipulated the manner in which the order could be recovered or enforced.

> The claimant's claim for interest under s 27 of the 2007 Act would be dismissed. Further, the claimant received a repayment supplement and was not, therefore, entitled to any further sum by way of interest.

Comments – This case is important as it looks at a number of the aspects of the rules in relation to set off.

Emblaze Mobility Solutions Ltd v Revenue and Customs Comrs [2012] All ER (D) 63 (May)

Exemption does not apply

Prudential transferred its general insurance business to Winterthur. Under the transfer agreement, Winterthur was to pay Prudential £350m on completion together with commission on renewals of Prudential policies which were in existence at the time of transfer. For various reasons, Winterthur transferred the business to another company, UKI, which was part of the Royal Bank of Scotland (RBS) group.

Prudential claimed exemption from VAT in respect of commissions on the basis that they were payments for the transfer of a business as a going concern. Alternatively, it said the commissions should be exempt because they were payments for insurance brokerage and insurance agency services within article 13B(a) of the Sixth Directive and VATA 1994, Sch 9 group 2 item 4.

The VAT tribunal dismissed the appeal. Given that the financial impact of the appeal would be borne by RBS, as it would have to pay the relevant VAT, RBS was substituted as the appellant so that it took the appeal to the High Court.

Decision:

The High Court said that the only transferee in respect of the transfer of Prudential's business was Winterthur. Furthermore, Prudential did not qualify as an insurance broker or agent. It had not brought the insurers and the potential policyholders together, it had instead handed over details of customers to UKI. Prudential did not carry out any preparatory work or provide insurance intermediary services. The exemption did not apply.

The taxpayer company's appeal was dismissed.

Royal Bank of Scotland v CRC, Chancery Division, 17 January 2012

Parking charges

A company (V) operated a 'parking control' service for landowners. It did not account for VAT on all of the amounts which it received from motorists. HMRC issued an assessment, and V appealed, contending that the amounts in question were penalties for contraventions which should be treated as damages for trespass and as outside the scope of VAT.

Decision:

The Upper Tribunal rejected this contention and dismissed the appeal, specifically distinguishing the case of Bristol City Council (VTD 17665), which V had cited as an authority, on the grounds that in that case there had been a contract between the council and the motorist, whereas in this case there had been no such contract. The payments were consideration for the supplies which V made to the landowners.

Comments - The Upper Tribunal upheld HMRC's view that VAT was chargeable on the whole of the payments which the company received.

Vehicle Control Services Ltd v HMRC (Upper Tribunal)

Input tax claimed without supporting invoices

A woman (W) registered for VAT and submitted a return claiming a repayment of £60,038. When HMRC queried the claim, W stated that she had purchased an aeroplane, a car and a piano. However she failed to produce any invoices in support of her claim. HMRC formed the opinion that the claim was fictitious, and imposed a penalty under VATA 1994 s 60.

Decision:

The First-tier Tribunal dismissed W's appeal, finding that 'the purchases never occurred' and that the repayment claim was dishonest. (The Tribunal awarded costs to HMRC.)

Comments - The First-tier Tribunal upheld HMRC's view that the appellant had made a fictitious repayment claim, and upheld the penalty which HMRC had imposed under VATA 1994 s 60. The Tribunal also awarded costs to HMRC.

Miss S Walker v HMRC TC01919

Company reclaiming input tax without accounting for output tax

A company (B) which operated a residential care home from 1986 to 1992 registered for VAT in 2008, and submitted a return reclaiming input tax of £47,713 without declaring any output tax. HMRC rejected the claim and B appealed. The First-tier Tribunal dismissed the appeal.

Decision:

The Upper Tribunal upheld this decision, finding that B had 'understated the amount of output tax actually due' and holding that the effect of VATA 1994 s 25 was that 'no amount of VAT fell to be repaid to the appellants because the output VAT chargeable on the appellants' supplies for the period exceeded the creditable input tax claimed in the period'.

Comments - Not surprisingly, the Upper Tribunal upheld HMRC's view that a company cannot reclaim input tax without also accounting for the appropriate amount of output tax.

Benridge Care Homes Ltd v HMRC (Upper Tribunal)

Pitfalls and planning with the VAT option to tax **(Lecture B719 – 22.14 minutes)**

No such thing as an opted property!

What exactly is an option to tax election? In a nutshell, an option to tax election made by a taxpayer means that income he generates from a specific property will be taxable (subject to 20% VAT) rather than exempt. This outcome also applies to the proceeds from selling the property – and don't forget that SDLT (stamp duty land tax) is charged on the VAT inclusive price of the property.

A myth about the option to tax regulations is that there is such a thing as an 'opted property'. This is not correct and each taxpayer makes his own decision about whether he opts to tax his interest or otherwise:

Consider Chris who owns the freehold of an office block in Brighton, and has made an option to tax election on the property. He therefore charges VAT on the rent he earns from a firm of architects. The architects sublet part of the office to an insurance broker. The architects are not obliged to opt to tax their interest in the building and charge VAT to the insurance broker – but it may be in their interests to do so.

If the architects do not opt to tax the property their rental income from the insurance broker will be exempt. The insurance broker would be pleased that he has not been charged VAT on the rent but the architects are now partially exempt. Unless the input tax relating to the letting is de-minimis there will be a restriction on input tax recovery for the architects. The architects could opt to tax the property and the rental income would then be taxable and they would be fully taxable with no input tax restrictions. They would need to ensure that any rental agreement with the insurance broker allows them to add VAT to the agreed rental charge – if not any option to tax would be counter-productive as they would need to account for the VAT at one-sixth of the agreed rental income.

Sale of an opted property

Ordinarily when you sell an opted property you would expect to charge VAT on the sale. There are however a number of occasions when you are not permitted to charge VAT on the sale of an opted property.

Where the buyer issues Form 1614D by exchange of contracts, the option to tax is not effective on the sale. This is an issue if the seller is within the capital goods scheme as the sale is now exempt. The seller will then have to repay a proportion of input tax to HMRC. If the sale is in year five of the seller's ownership period then the input repayment will amount to 50% of the input tax that the seller recovered on purchase five years ago. A sale in year six would trigger a 40% repayment and so on.

If the buyer omits to issue Form 1614D by exchange they may try and issue the Form in between exchange and completion. The seller now has the right to reject the Form and should do so if they are within the capital goods scheme.

Any developers wishing to avoid VAT on purchase must ensure they issue Form 1614D to the seller by exchange of contracts. Failure to do so may see their Form being rejected. Any VAT then paid on purchase will increase their SDLT charge.

Input tax on purchase will only be recoverable to the extent that it relates to an onward taxable supply – not something we could guarantee in the current climate.

It should be noted that Form 1614D can be issued to cover part of the property. For example, if a developer bought an opted hotel and had the intention of converting the top two floors into flats whilst leaving the ground floor as commercial. The developer would certify an intention to convert two thirds of the property into residential. The seller would then charge VAT on one third of the sale price with the remaining two thirds being exempt.

Housing Associations enjoy similar rules when buying opted land or opted property but their confirmation would be on Form 1614G.

DIY housebuilders buying opted land enjoy similar rules but with no formal certification.

Sale of an opted tenanted property

Commercial tenanted properties are normally opted by the landlord so as to ensure their rental income is taxable.

When a landlord sells their opted commercial property this can qualify as a transfer of a going concern (TOGC). To ensure the transaction is outside the scope the buyer must opt to tax before the relevant date (normally completion) and provide proof to the seller that the option to tax has been made and that it will not be disapplied under Schedule 10 Para 12 to 17.

It should be noted that an empty property could qualify as a tenanted property if there is a committed tenant due to occupy the property in the near future.

When acquiring an opted tenanted property via the TOGC route, the buyer must enquire into the capital goods scheme (CGS) position of the seller. The buyer will inherit the sellers CGS obligations so must have full details of the assets VAT history from the seller. This will include original purchase price and input tax recovery since purchase.

Sale of a pub to the tenant

Imagine the following situation:

A major UK brewery has decided to sell the freehold of one of its pubs to the tenants who have traded from the pub as a limited company (husband and wife are equal shareholders) for the last ten years.

The tenants have paid a monthly rent to the brewery during this time – based on the turnover of their sales (turnover rent).

The brewery has an option to tax election in place on the pub because it spent a lot of money refurbishing it many years ago and wanted to claim input tax on the building costs. So it has charged VAT on the monthly rent to the tenants (correctly)

What are the VAT issues of the sale from the brewery to the tenants?

The key issue is that the business of the brewery has been 'property rental'; the activity of the tenants is to sell food and drinks as publicans. This is a different activity so therefore fails an important condition of the TOGC rules i.e. the same activity must be continued by the buyer. This means we now have a sale of assets taking place rather than the sale of a business and the option to tax election means the sale of the pub building is standard rated.

What are the disadvantages as far as the tenants are concerned? They will be able to claim the VAT paid on the purchase price as input tax – but there will be a temporary cash flow problem between when the VAT is paid to the brewery and when it is claimed on their next return.

The other problem for the tenants is an increased exposure to stamp duty land tax (SDLT).

Example

Harveys Brewery has sold The Boot Inn to Frank and Betty Ltd (tenants) for £230,000 plus VAT of £46,000. The SDLT charge is based on the VAT inclusive price of £276,000 and because this amount exceeds £250,000, the SDLT bill is based at a 3% rate i.e. £8,280.
A sale of £230,000 without VAT (i.e. less than £250,000) would have produced an SDLT bill of £2,300 i.e. £230,000 x 1%.

As a useful planning tip, Frank and Betty should ask the brewery if its option to tax election on The Boot Inn has been in place for twenty years or longer. An election can be revoked when it has been in place for twenty years or more. Form VAT1614J needs to be completed by the brewery and submitted to HMRC, so that its future income from the building again becomes VAT exempt rather than standard rated i.e. including the sale proceeds.

Another important point is that an election does not apply to any residential part of a building. So if The Boot Inn includes a landlord’s flat, an apportionment of output tax is needed (based on market values), as this part of the sale will be VAT exempt.

Alternatively if Frank and Betty bought the pub as a partnership and continued letting it to Frank and Betty Ltd we would have a TOGC. Frank and Betty are taking over the property rental activity of the brewery because they are buying a building with existing tenants in place. This means the proceeds of the sale are outside the scope of VAT as the sale of a property rental business i.e. a TOGC arrangement is created.

Frank and Betty would need to register for VAT as a partnership prior to completing the purchase – intending trader registration. The partnership would make an option to tax election on The Boot Inn building – VAT1614A should be completed at the same time as applying for VAT registration. Prior to completion the partnership must give evidence of both VAT registration and the option to tax election to the brewery. As an anti-avoidance measure, Frank and Betty partnership must also confirm in writing to the brewery that the option to tax will not be disapplied under Schedule 10 Paras 12 to 17.

Should we always opt to tax commercial property to recover input VAT?
Input tax is recoverable if it has a direct and immediate link to a taxable supply.

If you are occupying the property for taxable purposes any input tax incurred in acquiring and maintaining the property will be recoverable without the need to opt to tax. Remember – an option to tax is effective for a minimum of 20 years so the decision to opt must be considered carefully.

Example

Dave owns a car repair business and is VAT registered. He trades from rented property and is charged VAT on the rental as the landlord has opted to tax the property. Dave has agreed to purchase the property from the landlord for £140,000 plus VAT. The purchase is not a TOGC as Dave will have an owner-occupied property post purchase rather than the required tenanted property for a TOGC to be in point.

Dave does not need to opt to tax his interest in the property to recover the VAT charged on purchase as he gets full input tax recovery because his business use (car repairs) is taxable. So he gets input tax recovery on the purchase of the property in exactly the same way as he reclaims input tax on his accountancy fees, telephone bills and computer costs.
The option to tax is only necessary to create taxable income for a business (rent/selling proceeds etc) instead of exempt income. If Dave decided to sublet or fully let the premises in the future, he could then consider the benefits of making an option to tax election at that stage.

Dave could make the purchase into a TOGC by buying the property jointly with his wife and then renting it to his sole trader business. The only advantage of making the purchase into a TOGC would be to save the 1% SDLT on the VAT inclusive purchase price of £168,000. An SDLT saving of £1,680 may not be enough to make this route attractive but it is an option we need to make Dave aware of.

<u>How do we opt to tax?</u>

Another important point about the option to tax regulations is that there are two stages in the process:

1. a taxpayer makes his decision to opt to tax the property (based on the benefits he considers to be worthwhile)

2. he then notifies the election to HMRC on form VAT1614A. In cases where exempt rental income has already been generated from the property, he may need HMRC permission to opt to tax his interest in the property by completing form VAT1614H.

For your option to tax to be valid you must normally make your notification within 30 days of your decision. You can ask HMRC to accept a notification made more than 30 days after your decision but they will not do so unless they are satisfied that you made your decision to opt at the relevant time.

If you would like HMRC to consider accepting a belated notification, you should enclose with your notification an explanation of your circumstances and any evidence that will help to show HMRC that the decision was made at the relevant time.

HMRC will normally accept a belated notification if:

- you provide direct documentary evidence that the decision was made at the relevant time (e.g. copies of correspondence with third parties referring to the option to tax), or
- you provide evidence that output tax has been charged and accounted for and input tax claimed in accordance with the option; and a responsible person (such as a director) provides a written declaration that the decision to opt was made at the relevant time and that all relevant facts have been given.

HMRC might accept a belated notification in other circumstances. This will depend on the facts of your case

<u>Can you deregister with an opted property?</u>

The answer is yes providing your projected taxable income (the rent) does not exceed £75,000. Other taxable income would also have to be brought into this calculation but let us assume that you only have the opted property.

The option to tax will still be in place post deregistration but you will not charge VAT on the rents as you are not registered. If the rentals increased you may have to register for VAT at some point as the rental remains a taxable source of income.

So it is possible to deregister with an opted property but you must make sure that no VAT was recovered on the purchase of the opted property – otherwise you will have a deemed supply on deregistration!

<u>Mollan & Co Ltd</u>

A company deregistered for VAT in April 2009. In July 2005, it had opted to tax a building it owned, and had recovered input tax of £42,875. It failed to declare output tax on the deemed supply of the building under Sch.4 para.8 VATA 1994: this should have been accounted for on the final return to 2 May 2009.

It seems that someone must have realised that this was a mistake, because the company tried to re-register in October 2009, and rang the Advice Line to discuss the possibility of reinstating the original registration. It was told that this would not be possible.

HMRC assessed the deregistration charge at £30,000 in January 2010, and imposed a 15% penalty for a careless error that had not been disclosed. The maximum penalty would be 30% of the potentially lost revenue, and HMRC contended that the maximum mitigation had been allowed.

The trader argued that it had disclosed the problem to HMRC when it tried to reinstate the registration in October 2009. The Tribunal examined the correspondence and representations from the taxpayer and disagreed: at no point had the error been explained by the trader. HMRC had identified it from information supplied, but it had not been voluntarily disclosed. The penalty was confirmed at 15%.

Contributed by Dean Wootten

VAT annual accounting **(Lecture B720 – 18.11 minutes)**

The annual accounting scheme enables qualifying businesses with taxable turnover up to £1.35m to submit one VAT return each year. The business will need to pay its annual VAT liability via monthly instalments followed by a balancing payment two months after the year end.

The scheme has many advantages including:

- budgeted cash flow as the business knows what VAT needs to be paid via instalments during the tax year
- only one VAT return needs to be submitted each year. This means less administrative time is spent preparing the VAT return be it client staff or professional advisor
- reduced exposure to penalties especially tax point errors
- reduced exposure to default surcharge penalties - especially relevant with the new rules coming in
- businesses have 2 months at the end of the tax year to submit the VAT return and balancing payment rather than one
- the VAT return stagger can be aligned to the financial year end in order to simplify year end accounting requirements / obligations

Under annual accounting a business can choose to either pay three quarterly instalments or nine monthly instalments during the year. The payments must be made by either direct debit, standing order or another form of electronic payment and businesses do not get a 7 day extension to submit the payment which would be allowed for businesses using the normal VAT accounting rules

When a business joins the scheme, HMRC will calculate the instalment amount and due date. If the business disagrees with the amount calculated or the business activities change, it should write to the Annual Accounting unit in Grimsby to request that the value of the instalments is amended. The nine instalments should total around 10% of the prior year liability – or 10% of the current year estimate if lower. The quarterly instalments will be around 25% of the previous years liability or 25% of the current year estimate if lower.

Businesses wishing to join the scheme need to complete and submit Form VAT 600AA to join the scheme.

Businesses should ensure that they give HMRC sufficient time to process their application, therefore the application should be submitted as soon as possible. Approval to join the scheme is normally takes effect from the first day of the period in which the application is finalised.

Correspondence concerning the annual accounting scheme, such as applications, changing bank details or year end should be sent to the following address:

HM Revenue & Customs
Annual Accounting Registration Unit
National Registration Service
Imperial House
77 Victoria Street
Grimsby
North East Lincolnshire
DN31 1DB

Please note that any general questions regarding VAT or annual accounting should be dealt with by the National VAT Helpline on 0845 010 9000

If HMRC grants permission to use the scheme, it will issue a letter confirming the following:

- amount of the instalment payment due each month / quarter
- confirmation of the payment method that should be used to make any instalments
- due date for submission of the annual return and balancing payment

Once a business is in the scheme, it can remain in the scheme until its taxable turnover reaches £1.6m per annum. Businesses will normally be withdrawn from the scheme at the end of the annual accounting tax year in which the business exceeded the threshold. However, if the business exceeds the £1.6m threshold significantly then HMRC may decide to withdraw the right to use the scheme before the end of the tax year.