Tolley®CPD

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Personal Tax

Statutory residence anti-avoidance (Lecture P776 – 15.00 minutes)

Where an individual becomes non-UK resident for a relatively short period, anti-avoidance legislation in Part 4 of Sch 43 FB 2013 provides that certain types of income which arose during that period will be treated as arising on the individual's return (and thus be subject to tax in the UK). This is the income tax equivalent of the CGT provisions found in S10A TCGA 1992. The rule will apply to individuals who have been resident in the UK for at least four out of the last seven tax years before leaving the UK and becoming non-UK resident for fewer than five years. In particular, it is designed to counter the 'post-departure' receipt of dividends from close companies which are paid out of 'pre-departure' profits as well as close company loans written off during the period of non-UK residence.

Another anti-avoidance measure in Para 23 Sch 43 FB 2013 targets individuals who:

(i) have been resident in the UK in one or more out of the last three tax years; and
(ii) have at least three UK ties for the current tax year; and
(iii) have been present in the UK at some point for more than 30 days but without being here at the end of the day (such days are referred to as 'qualifying days').

In this case, the excess of 'qualifying days' over 30 is added to the actual number of days spent in the UK for the purposes of the sufficient UK ties test. A simple illustration should make the position clear.

<u>Illustration</u>

Steven, who has three UK ties, does not meet either of the automatic tests for 2013/14. He was previously resident in the UK for 2011/12 and so counts as a leaver. In 2013/14, he spent 35 days in the UK when he was present at midnight, but was also present here on 57 other days, leaving the UK in the evening on each occasion.

Without the special deeming rule, Steven would be regarded as non-UK resident under the sufficient UK ties test, given that he only spent 35 days here (10 fewer than the permitted maximum). The excess of 57 over 30 gives Steven an additional 27 days which must be added to his tally of 35. In other words, he is treated as being in the UK for 62 days and, with three UK ties, this means that he is resident in the UK for 2013/14.

Contributed by Robert Jamieson

Tax-advantaged employee share schemes (Lecture P780 – 21.16 minutes)

In 2011, the Government asked the Office of Tax Simplification (OTS) to examine the four tax-advantaged share schemes with a view to:

(i) identifying areas where the legislation created undue complexities or disproportionate administrative burdens for scheme users; and
(ii) recommending a number of ways in which the schemes could be simplified.

The OTS report, which was entitled 'Review Of Tax-Advantaged Employee Share Schemes', was published on 6 March 2012. Draft provisions, addressing the OTS recommendations which the Government had decided to implement, were unveiled for consultation on 11 December 2012. Following the consultation process, several revisions were made to these proposals and the resulting legislation can now be found in Cl 14 and Sch 2 FB 2013.

The four schemes referred to above are:

(i) the Share Incentive Plan (SIP);

(ii) the Save As You Earn (SAYE) share option;

(iii) the Company Share Option Plan (CSOP); and

(iv) the Enterprise Management Incentives (EMI) share option.

A brief reminder of the salient features of each of these arrangements is set out below.

SIP

Introduced in FA 2000, the SIP is an all-employee share scheme which provides income tax, NIC and CGT advantages. The scheme must be approved in advance by HMRC and, once approved, employers can choose to incorporate, for the benefit of their staff, all or any of the following share awards:

(i) free shares worth up to £3,000 per tax year;
(ii) partnership shares worth up to £1,500 per tax year which employees may buy out of their pre-tax salary (subject to a 10% salary cap);
(iii) matching shares worth up to £3,000 per tax year – the employer company may award these shares free to employees at a ratio of up to two matching shares for every partnership share purchased; and
(iv) dividend shares – dividends from SIP shares up to an amount of £1,500 per tax year can be reinvested tax-free in dividend shares.

The relevant legislation is found in Ss488 – 515 and Sch 2 ITEPA 2003. There are currently less than 900 companies which operate SIPs. Very few of these are private companies.

SAYE

Introduced in FA 1980, SAYE is an all-employee share option scheme under which share options are linked to SAYE savings contracts for employees. It allows staff either to take their savings in cash at the end of the savings period or to use the money to exercise their options and acquire shares in the employer company. The ability to take savings as cash means that SAYE arrangements are typically viewed as a 'no risk' employee scheme. Options may be granted at a discount of up to 20% of the shares' market value at the time of the grant. Here, too, HMRC approval is needed before the scheme can go live. The rules are set out in Ss516 – 520 and Sch 3 ITEPA 2003. Some 600 companies presently use SAYE schemes, involving more than 750,000 employees.

CSOP

CSOP is a discretionary share option scheme which was brought in by FA 1984. Initially, it was used mainly for executive directors, allowing a grant over shares with a value of up to £100,000 or four times salary, whichever was the greater. Income tax relief was available on the exercise of the option and the CGT payable on the sale of the shares represented a useful incentive because of the considerable difference between income tax and CGT rates at the time. In 1995, the Greenbury Report was published. This Report arose partly out of concerns about the large gains made by directors from the exercise of their share options, particularly in relation to the recently privatised utility industries. The Report criticised this form of share option for two main reasons:

(i) for providing 'windfall gains' reflecting general market movements rather than the efforts of directors; and
(ii) for failing to encourage directors to become long-term shareholders in their companies.

Following the Greenbury Report, this share option arrangement was restyled as a CSOP in FA 1996 and the individual limit was reduced to £30,000, a figure which has not altered since then. This had the immediate effect of making the scheme significantly less attractive as a method of incentivising and motivating higher-earning employees. Full details about CSOPs can be found in Ss521 – 526 and Sch 4 ITEPA 2003. The use of CSOPs has dropped considerably in recent years. National statistics indicate that there are now fewer than 2,000 live schemes, compared with more than 5,000 at the turn of the century.

EMI

Like SIPs, EMIs came into being in FA 2000. The EMI share option scheme is a flexible and tax-efficient arrangement for rewarding key members of staff in small and medium-sized companies – in other words, it too is a discretionary scheme. Subsequent beneficial changes have been:

(i) an increase in the maximum value of the company's gross assets from £15,000,000 to £30,000,000; and
(ii) a rise last year in the total value of unexercised options for any individual from £120,000 to £250,000 (but it should not be overlooked that this limit also includes unexercised CSOP options where the employer operates both types of scheme).

For the smaller private company, EMI is an attractive option arrangement which offers a number of advantages over the schemes mentioned above. The key ones are as follows:

(i) restricted shares – options can be granted over shares with restrictions, including shares subject to pre-emption rights;
(ii) self-certification – a simple agreement can be drawn up between the option-holder and the grantor without seeking prior approval from HMRC (but once the option has been granted, the Small Company Enterprise Centre in Nottingham must be notified within 92 days);
(iii) valuation – there is no specific requirement to seek a formal valuation of the shares prior to the grant of an option, although in practice this is usually advisable;
(iv) the ability to grant options at a discount and/or with performance conditions attached; and
(v) no time limits – unlike approved schemes, there is no minimum time requirement for options to be held before they can be exercised.

The EMI legislation is set out in Ss527 – 541 and Sch 5 ITEPA 2003. Nearly 11,000 companies use an EMI scheme.

The changes

Cl 14 and Sch 2 FB 2013 amend the rules for the various tax-advantaged employee share schemes in seven main respects. The changes, which, with one exception (see (vi) below), take effect from the date of Royal Assent, are as follows:

(i) In particular, the requirement for SIP, SAYE and CSOP schemes to include a specified retirement age in their rules is to be removed.
(ii) Leaving employment (other than on retirement) and qualifying for favourable tax treatment as 'good leavers'. Two issues are addressed in this regard:
    - there are to be what the Treasury call 'simpler and more consistent' rules for SAYE and CSOP schemes; and
    - new provisions are being introduced for SIP, SAYE and CSOP schemes where there has been a cash takeover of the scheme company.
(iii) Material interest' rules. This prohibition is to be removed for SIP and SAYE schemes and, as far as the CSOP legislation is concerned, the relevant figure is to be adjusted upwards from 'more than 25%' of the company's ordinary share capital to 'more than 30%'.
(iv) The fourth one withdraws the rule that shares awarded under a SIP and shares received under SAYE and CSOP schemes can only be subject to certain kinds of restriction.
(v) The fifth one changes the mechanism for determining the number of SIP partnership shares which an employee can buy.
(vi) The sixth one looks at SIP dividend shares. The £1,500 limit on the reinvestment of cash dividends has been removed for 2013/14 onwards. The three-year time limit for reinvesting dividends has also been abolished from the same date.
(vii) The final one amends S532 ITEPA 2003 to extend from 40 days to 90 days the time available for those holding EMI share options to exercise them with favourable tax treatment after the occurrence of a 'disqualifying event' (eg. the company ceasing to meet the trading activities requirements in Paras 13 – 23 Sch 5 ITEPA 2003).

Contributed by Robert Jamieson

Employee shareholder status (Lecture B778 – 15.05 minutes)

Background

In a controversial move intended to improve flexibility in the labour market, the Government introduced legislation in the Growth and Infrastructure Act 2013 creating a new class of employee labelled "an employee shareholder". That Act makes amendments to the Employment Rights Act 1996 and Finance Bill 2013 includes provisions for certain tax reliefs in respect of shares issued to employee shareholders.

An employee shareholder is an employee who has, by agreement with his employer, accepted a reduction in certain employment rights in exchange for shares in his employer company or in its parent company. This news item explains the procedure for making an employee shareholder agreement, the employment rights that are varied as a result of that agreement and the tax provisions applicable to shares issued under an employee shareholder agreement.

The provisions creating employee ownership will actually come into force at a date to be set by the Secretary of State, expected to be in autumn 2013.

Making an employee shareholder agreement

Before an agreement is made, the employer company must issue to the employee a written statement setting out what employer shareholder status means in terms of changes to normal employee rights, as well as details of the shares that are to be offered under the agreement and the rights attaching to those shares.

The employee must then, at the expense of the employer, be provided with independent advice about what the terms and the effect of the proposed agreement would mean for him.

There is then a seven-day cooling-off period before the employee can, if he still so wishes after consideration of the independent advice, enter into the employee shareholder agreement.

An employee cannot be compelled to enter into an employee shareholder agreement and amendments to ERA 1996 give employees new protection against any adverse treatment by the employer as a result of their failure to sign up to such an agreement. The grounds for unfair dismissal are extended to include dismissal because the employee has refused to accept an offer to become an employee shareholder. See ERA 1996, ss 47G and 104G.

Shares that can be used

The employer has to provide shares worth at least £2,000 to the employee, as at the date upon which the shares are issued or allotted to him. There is no upper limit as to the value of the shares that can be given under the agreement (although there are limits to the favourable tax treatment of the shares -- see below). The shares have to be fully paid up and can be shares in the employer company or it its parent undertaking, but beyond that there are no rules regarding the class of shares that can be used, or any rights or restrictions that may attach to them.

However, the written statement that the employer company has to issue to the employee setting out the terms of the agreement must specify:

- whether the shares carry any voting rights
- whether the shares carry any rights to dividends
- whether, in the event of the company being wound up, the shares would entitle the employee to participate in the distribution of any surplus assets
- if there is more than one class of shares in the company, how the rights to dividends, voting rights and assets on a winding up of the employee shares compare with the rights attaching to the shares in the largest class of shares (or second largest if the employee is being offered shares of the largest class)
- whether the shares are redeemable, and if so, at whose option
- what, if any, restrictions are attached to the shares regarding their transferability
- whether the employee shares would be excluded from shareholder's rights of pre-emption, and
- how, if at all, a decision by the holders of the majority shareholding to sell their shares could affect the rights of minority shareholders

Employee rights covered by the agreement

The employer has no discretion to decide which employee rights should be given up or varied under an employee shareholder agreement. These are set out in the statute (in ERA 1996, s 205A(2)). An employee shareholder gives up the rights:

- to request to undertake study or training
- to request flexible working arrangements, other than if returning from parental leave, when the employee can make a formal request for flexible working, but no later 14 days after their return to work
- not to be unfairly dismissed (other than for a reason considered to be automatically unfair, or in circumstances that contravene the Equality Act 2010), and
- to receive a statutory redundancy payment

Additionally, the amount of notice that an employee shareholder has to give of his intention to return to work from statutory maternity, adoption or additional paternity leave is increased to 16 weeks.

Tax treatment of shares issued under the agreement

Income tax

Under the provisions of Part 1 of Schedule 22 to Finance Bill 2013, when the employee shareholder shares are received by the employee he will be treated as receiving earnings from employment equal to the actual value of those shares less a deemed payment of £2,000. This means that if the basic £2,000 worth of shares are offered under an employee shareholder agreement, it will not give rise to any charge to income tax.

Anti-avoidance provisions are included in Part 1 of the Schedule to prevent employees receiving employee shareholder shares from a number of associated companies and benefiting from the £2,000 deemed payment in respect of the shares from each.

The £2,000 deemed payment is not available if the employee shareholder, or a person connected with him, has a material interest in the company or a parent undertaking. A material interest for this purpose means 25% of the voting rights, or in the case of a close company, the right to receive 25% of the company assets in the event of a winding-up. In each case any rights held by connected persons are added together. If an employee shareholder does have a material interest, he is treated as receiving earnings from the employment equal to the full market value of the shares.

If, after leaving the employment, the employee shareholder sells the employee shareholder shares back to the company, a new section 385A inserted into ITTOIA 2005 will prevent an income tax charge arising on the proceeds of that sale, provided the employee shareholder shares come within the CGT exemption, as discussed below.

Capital gains tax

Under a new exemption to be inserted at TCGA 1992, s 2346B applying to employee shareholder shares worth up to £50,000 on acquisition, the first disposal of those shares will not be treated as a chargeable gain. Normal CGT rules will apply to any subsequent disposal of those shares. In looking at that £50,000 limit, all employee shareholder shares held in associated companies should be added together.

The CGT exemption will not apply to employee shareholder shares issued to an employee who had a material interest in the company either when the employee shareholder shares were acquired or at any time during the previous 12 months. A material interest for this purpose means 25% of the voting rights, or in the case of a close company, the right to receive 25% of the company assets in the event of a winding-up.

If the employee disposes of the employee shareholder shares to his spouse or civil partner, the no gain / no loss rule that would normally apply to transfers between spouses / civil partners will be disapplied by provisions in Part 2 of Schedule 22. Instead the transfer will be treated as a disposal at market value. The employee will benefit from the CGT exemption for employee shareholder shares and the spouse / civil partner will have the market value of the shares as at the date of the transfer as their base cost.

Corporation tax

Subject to certain conditions (see CTA 2009, s 1006 onwards) an employer company that provides its employees with shares in that company, or a parent company, can qualify for corporation tax relief in respect of the value of the shares provided. This relief will also be available if the shares provided to employees are employee shareholder shares. Part 3 of Schedule 22 makes amendments to those rules so that they will apply ignoring the £2,000 payment the employee is deemed to have made for the shares.

Commencement

All the tax changes concerning employee shareholder shares will take effect from a date to be set by Treasury order, anecdotally expected to be sometime in the autumn.

Key points for employers

The essential point to remember is that employee shareholder status can only be achieved by a genuine agreement. The employee cannot be forced to sign up for it and has new protection under the ERA 1996 against any detriment suffered as a result of a failure to sign up to an employee shareholder agreement and any dismissal due to a refusal to sign up will be deemed to be an unfair dismissal under that Act.

Another important point is that anyone with a 'material interest' in the company cannot qualify for the tax exemption in respect of the shares, which would usually rule this out as an option for delivering tax-free shares to family members working for a close company. Also start-up companies may, in practice, find themselves excluded as the value of their total share capital may not be sufficient to allow £2,000 worth of shares to be issued to each employee shareholder.

Employers cannot choose what rights the employee would surrender as part of the employee shareholder agreement, but need to think carefully about the number and description of the shares they propose to offer in exchange. Employers may find it helpful to seek legal advice on the pros and cons of various classes of shares it might offer and the various conditions and restrictions that it might apply to them. The package would need to be sufficiently attractive to employees to encourage take-up but it is worth remembering that any shares worth over £2,000 will result in a tax charge on the employee, subject to tax and NIC.

Having determined the shape of the share package being offered as part of the employee shareholder agreement, the employer must issue to each employee invited to enter into the agreement a full statement setting out exactly what is on offer and what the changes to his employment rights would be. The employer must then pay for independent advice to be provided to each interested employee and wait seven days after that advice is given before being certain whether any or all of those interested employees will actually sign up.

Given the legal costs involved, employers should weigh up whether the rights given up by the employees represent a fair bargain in terms of how they will benefit the company in terms of increased flexibility or reduced employer obligations.

Employee shareholder status has had something of a rough ride through the Parliamentary process, attracting a fair amount of detrimental publicity along the way. It is therefore possible that employees will reject any offer of employee shareholder shares on the basis of that adverse publicity rather than actually weighing up the pros and cons of any actual offer.

The benefits for employers that can result from employee share ownership, improved loyalty, productivity etc may alternatively be delivered via one of the tax-advantaged share schemes such as SIPs or EMI.

Contributed by Cheryl Scott, Tolley Guidance

Use of alphabet share arrangements (Lecture P777 -13.59 minutes)

It has become increasingly important for employees in a company to participate in the equity giving them not only a stake in the future growth of the business but the opportunity to extract funds from the company by way of dividend which can avoid the payment of higher rates of tax and national insurance contributions.

At the outset it should not be overlooked that shares provided to employees and office holders will fall within the employment related securities provisions ("ERS"). Where shares are acquired at undervalue there will be an up front tax and possibly NIC exposure. The extent of this exposure will depend on the value of the shares and where there is a history of regular dividends this can be an influencing factor in relation to valuation. There will of course also be reporting obligations under Form 42.

For various reasons shareholders may want to take different dividends and where there is only one class of shares this can be achieved by the use of dividend waivers. Such arrangements can be cumbersome and are dependent on there being sufficient reserves to cover the full dividend including the waived amount. In such circumstances, the use of alphabet shares may be more efficient. Such arrangements involve the issue of "A" shares, "B" shares, "C" shares etc. which can be used to pay different dividends to key employees or family members. Significant tax and NIC savings can be made as a result of an appropriately structured company. There are however tax risks.

Post -acquisition benefits

HMRC may review the arrangements to ensure the planning and implementation is effective and that the ERS provisions found at Part 7 ITEPA 2003, do not come into play.

Arrangements which are most at risk from HMRC attack under the post- acquisition benefits provisions (s447 ITEPA 2003) are where all employees are allotted different classes of shares A-Z which provide rights to different dividends and nothing else. In such cases, it is clear that dividends appear to be paid as remuneration and a reward for the work contribution from each shareholder and the benefit derived from the arrangements would be treated as employment income subject to the income tax charge.

HMRC state in their manuals that where there is no complex and contrived scheme to avoid tax and NIC they will not seek to use these rules so the question arises as to what might be acceptable and what actually constitutes avoidance and is more at risk of falling into a charge under the ERS provisions.

This issue has taken on further significance following the recent decision to withdraw the appeal against the Court of Appeal decision in *PA Holdings v Revenue and Customs Commissions [2012].* This case has raised concerns that "normal" planning which may involve alphabet shares will now be more at risk of a challenge.

P A Holdings Ltd

The company decided to enter into complex arrangements involving offshore companies whereby cash bonuses were re-routed so they were paid as dividends. HMRC took the view that dividends were emoluments from employment and therefore subject to PAYE. The company argued that the payments derived from ownership of shares and were taxable as dividends which took priority in the first instance, irrespective of whether or not they were emoluments, a point accepted by the tribunals. The decision was overturned by the Court of Appeal which stated that where income is an emolument from employment this precludes it from being taxed as a dividend. A charge under PAYE therefore arises.

Can alphabet shares still be used?

It is no secret that the vast majority of private companies make the decision on whether to take dividends or salary on the amount of tax which is payable. Furthermore alphabet shares can be viewed as a mechanism to add flexibility to profit extraction and general remuneration planning. The concern is that any arrangements aimed at paying dividends rather than salary will now be exposed to an attack following PA Holdings. While those cases on all fours with PA Holdings will be clearly in the firing line, it is worth remembering that this case involved complex arrangements for a large company which are someway off those found in smaller company arrangements which would not typically enter into such sophisticated arrangements.

Each case needs to be considered on its own facts but as a general rule the use of alphabet share type arrangements will have a low risk of attack in the following situations:

Founders/controlling shareholders – Such persons should be free to organise their tax affairs in the most tax efficient way and this may involve the extraction of regular dividends which are paid as part of the return on their capital investment in the business. In the context of family companies it is important that dividends paid to one person do not find their way back to another.

"Partnership" companies - This is where the business is essentially like a "partnership" although it is carried on through the legal structure of a company. Co-owners will each hold shares which have full rights and separate classes of shares may be held which allow different dividends to be paid. As long as the level of dividend paid is not linked in any way to work undertaken by the shareholder if such arrangements are set up correctly the risks are low.

Partly-paid shares – This can be a genuine commercial alternative to the use of alphabet shares. Under this arrangement, beneficial interest in a new issue of shares passes to the employee on the understanding the employee will pay full value but part of the share capital is left uncalled. Employees carry commercial risk in respect of uncalled amounts and with differing paid-up amounts the shareholders have different levels of risk and exposure which can justify different levels of dividend. While HMRC may still query the use of partly paid shares where justifiable salaries are also paid this may be defended.

EMI shares – Where alphabet shares are used in conjunction with an approved share scheme such as an Enterprise Management Incentive (EMI), HMRC are more likely to take a relaxed view to the arrangements especially where separate share classes exist say for directors and non-directors.

Summary

The key to using alphabet shares is that the arrangements must not be contrived or give the perception they are aimed clearly at re-routing salary into dividends. The uses of A-Z type arrangements, with this in mind, are clearly at risk. The shares issued to the shareholders should carry more than just a right to income and the dividends paid should not be linked to services provided but clearly a return on the investment.
The ministerial statement shown in HMRC's manuals at ERSM90060 would appear to support this.

In summary, the arrangements are likely to be effective where the following can be put in place:

- Shares must have the same rights including rights to vote and a share in net assets following a winding up of the company;
- Reasonable salaries should be paid to employees in line with the national minimum wage but preferably commensurate to their duties;
- Where such arrangements are considered for employees structuring them via an approved scheme or partly-paid shares may help lower the tax risks.
- In husband and wife cases, the dividend should be paid to the spouse without an obligation for it to be returned to the main shareholder.

Contributed by Martin Mann

Corporate bonds stripped of interest: profit on sale

An individual (S) purchased certain corporate bonds, marketed by a bank, which had been stripped of interest for a certain period. At the end of the period, S sold the bonds. HMRC issued amendments to his self-assessment, treating the profits which he had made on the sale of the notes as discounts, which were chargeable to income tax under what is now ITTOIA 2005 s 381.

Decision:

The First-tier Tribunal dismissed S's appeal, applying the principles laid down by the HL in National Provident Institution v Brown 8 TC 57.

Comments - This is the second recent case concerning 'stripped bond' avoidance schemes, following HMRC's victory in the similar case of M Healey v HMRC (TC02591). HMRC issued a 'spotlight' news release on 18 April, stating that they will seek full settlement of outstanding liabilities in respect of such schemes. Similar products were marketed by other banks, so the amount of tax at stake appears to be substantial. (The transactions which were the subject of this case took place before the introduction of the specific anti-avoidance legislation now contained in ITTOIA 2005 ss 452A–452G.)

P Savva v HMRC (and related appeals) TC2625

Payment received by hedge fund manager

A hedge fund manager (M) took up employment with a Luxembourg bank (D). D's directors agreed to pay M an 'investment bonus' as consideration for M introducing certain business to D. However, in November 2001 D made M redundant without paying him the promised 'investment bonus'. M began legal action against D. The action was settled out of court, and D agreed to pay M compensation for the loss of the 'investment bonus' (in addition to the redundancy payment which M had already received). In his 2002/03 return, M treated the compensation payment as a capital receipt. Following an enquiry, HMRC issued a closure notice treating it as chargeable to income tax (under Schedule Case VI under the legislation then in force).

Decision:

The FTT dismissed M's appeal, holding that the agreed 'investment bonus', and thus the compensation payment, was a reward for the part which M had paid in enabling D to acquire additional business, and was not a capital sum.

Comments - The FTT upheld HMRC's contention that the payment which the appellant had received was income rather than capital, and was taxable under Schedule D Case VI under the legislation in force at the relevant time.

P Manduca v HMRC TC2648

PILONs are taxable

The taxpayer received payments from his employer in respect of his employment being terminated. Under a compromise agreement, he received a payment of £38,522 in lieu of notice which was subjected to tax and National Insurance. He then received another payment for the same amount described by the employers as “ex gratia”, also made subject to tax and National Insurance.

He submitted his self-assessment tax return claiming that the first £30,000 of the payments made to him should be tax free because he had been made redundant. HMRC disagreed, saying the payments were in lieu of notice and that he was contractually entitled to them.

Decision:

The First-tier Tribunal said that the compromise agreement did not supersede the taxpayer's contract of employment, but had to be read with it. The employer was contracted to make the payments to the taxpayer as part of his remuneration package. The compromise agreement made it clear that the payments were taxable, as had his own lawyer.

The taxpayer's appeal was dismissed.

Comments – The taxation of PILONs is an area which can easily be confused. Lord Browne-Wilkinson in Delaney v Staples set out the different types and their tax treatment. Ultimately in this case the PILON flowed from the contract and therefore fell to be fully taxable.

S Manley (TC2517)

Payments by employer on account

An employee (M) notified his employer (T) on 28 October 2007 that he wished to exercise his rights under a share option scheme, under which he paid £7,636 for shares which had a market value of £111,579. The scheme rules provided that M was required to reimburse T for the PAYE due in respect of the option. However, T did not provide M with details of the amount due from him until 28 March 2008. T paid this in April 2008. Subsequently HMRC issued an assessment on M, charging tax under ITEPA 2003 s 222 on the basis that he had failed to reimburse T within the statutory 90-day time limit. M appealed, contending that he had reimbursed T within a month of T informing him of the liability.

Decision:

The FTT allowed M's appeal, finding that the 'relevant date' for the purpose of s 222(4) was 28 March 2008, when T had informed M of the amount of the liability, rather than 28 October 2007, when M had informed T that he wished to exercise his option. Sir Stephen Oliver observed that s 222 was 'penal in its effect' and that 'where it applies, it brings into charge to tax notional amounts that would otherwise have no place in the taxing system'. It had been introduced 'to prevent grossly abusive schemes designed to avoid PAYE'. There had been 'nothing remotely abusive' about T's share option scheme, but HMRC had 'conducted their PAYE investigation without apparently troubling to look at the scheme rules. Nor did the assessing officer nor did the officer who conducted the review. The result that, unless (M) had appealed, HMRC would have earned a substantial windfall gain at his expense.' He concluded that 'when Parliament introduced section 222, they expected it to be properly and carefully exercised', and that it should not be treated as 'mechanistic in its effect'.

Comments - ITEPA 2003 s 222 applies where an employer makes certain types of notional payment which are treated as income of an employee and the employer is required to account for tax on that notional payment. It provides that, if the employee does not reimburse the employer within a 90-day period, 'the due amount is to be treated as earnings from the employment'. The Court of Appeal held that the provisions applied in the case of Chilcott v HMRC [2011] STC 456, where two company directors had failed to reimburse the company within the statutory time limit.

However, the FTT emphatically rejected HMRC's attempt to apply section 222 to the facts here, where the appellant was not a director of the company and where he had reimbursed his employer within 30 days of being informed of the amount due. The decision is notable for Sir Stephen Oliver's unusually strong criticisms of HMRC, which appear to be self-explanatory.

B Manning v HMRC TC2666

Loss claim: whether loan stock was a relevant discounted security

In March 2000, the taxpayer bought an off-the-shelf company and became its sole director. The company issued £6m loan stock, all of which he took at par. The loan stock certificate stated that the company would pay him the redemption proceeds of £11,780,974, ie £6m plus 7.25% of £6m a year, in 13 years' time.

In April 2000, the taxpayer formed The Nicholas Pike Settlement 2000 into which he placed the £6m loan stock which then had an open market value of £2,536,437.

In his self-assessment return, the taxpayer claimed a loss of £3,463,563, saying that the loan stock was a discounted security and that FA 1996, Sch 13 para 8 deemed a transfer between connected persons, ie the taxpayer and the trust, to be at open market value.

HMRC refused the claim.

The First-tier Tribunal (FTT) dismissed his appeal, finding that 'the transactions at issue in this appeal were part of a scheme of tax avoidance' and that P had 'intended to realise a loss for income tax purposes'. Judge Mosedale held that 'to avoid absurdity some of the language used by the drafters must be given a purposive rather than a literal reading'. It had been 'asymmetrical for the legislation to have an open market rule on transfers between connected parties without having the same open market value for grants and issues between connected parties'. The additional sum intended to be paid to P on the redemption of the loan stock should be treated as interest, even though it was not payable periodically. Accordingly, the loan stock was not a 'relevant discounted security'.

Decision:

The Upper Tribunal upheld this decision as one of fact, holding that the FTT had been 'plainly entitled' to conclude that the additional payment was interest.

Comments -: As was generally expected, the Upper Tribunal upheld the FTT decision in favour of HMRC. The purported loophole which the appellant sought to exploit was closed by FA 1996 Sch 13 para 9A, which was introduced by FA 2002 with effect from 25 March 2002, with the intention of ensuring that no loss relief could be claimed in a situation where the issue of the loan stock was at a price in excess of the market value and the issuer and creditor were connected parties. The case remains relevant as an illustration of the tribunals' attitude to attempts to create an artificial loss for tax purposes.

N Pike v HMRC (Upper Tribunal)

Property let to tenants: whether a business

A married woman (R) had acquired a large house in Belfast, which was divided into flats and let to tenants. In 2004, she transferred the house to a company. She claimed relief under TCGA 1992 s 162. Following an enquiry, HMRC issued a ruling that no relief was due, on the grounds that the property was an investment and was not a business.

Decision:

The Upper Tribunal allowed R's appeal (reversing the FTT decision). Judge Berner held that the activity which R had undertaken in respect of the property outweighed 'what might normally be expected to be carried out by a mere passive investor' and was sufficient in nature and extent to amount to a business for the purpose of TCGA 1992 s 162.

Comments - TCGA 1992 s 162 provides for rollover relief where a person transfers a business to a company as a going concern. The Upper Tribunal reversed the FTT decision and accepted the appellant's contention that the letting of the property was a business, which qualified for relief under TCGA 1992 s 162.

Mrs EM Ramsay v HMRC (Upper Tribunal)

UK/Ireland DTA

A former Inland Revenue officer (P) moved to the Irish Republic in 2004. In 2006, he began receiving a civil service pension. This was taxed in the UK, by virtue of art 18(2) of the double taxation agreement between the UK and the Irish Republic. In 2009, P appealed to the FTT, contending that art 18(2) was unfairly discriminatory, that this contravened EU law, and that his liability to UK tax should be restricted to the tax that would have been borne by an Irish citizen in his circumstances.

Decision:

The tribunal rejected these contentions and dismissed his appeal. Judge Gammie observed that there was no double taxation, and that 'a Member State is not in breach of its treaty obligations because it taxes differently and less favourably than some other Member State'.

Comments - The FTT upheld the long-established principle that double taxation relief is just that: it is relief for double taxation, not relief for higher taxation. Judge Gammie's comments are self-explanatory.

K Percival v HMRC TC2654

Application to pay backdated class 2 NICs

An individual (S) began self-employment in 1986. He paid income tax and class 4 NICs, but failed to pay any class 2 NICs until 2009/10. Subsequently, he applied to pay backdated contributions, to enable him to qualify for a full state pension. HMRC accepted his application for 2003/04 onwards, but rejected his application for 1986/87 to 2002/03, on the grounds that his failure to pay contributions at the appropriate time was attributable to a failure to exercise 'due care and diligence'. S appealed, contending that he had been misled by the accountant who had dealt with his tax affairs and who had failed to inform the DHSS that he was self-employed.

Decision:

The FTT accepted this contention and allowed the appeal. Judge Radford found that S had 'exercised due care and diligence by appointing an accountant to deal with all matters which arose in connection with his self-employment'.

Comments - Social Security (Crediting and Treatment of Contributions and National Insurance Numbers) Regulations, SI 2001/769, reg 6 only permits backdated payment of class 2 contributions where 'it is shown to the satisfaction of the Inland Revenue that the failure to pay the contribution before that time is attributable to ignorance or error on the part of that person and that that ignorance or error on the part of that person was not due to any failure on the part of such person to exercise due care and diligence'. In the leading case of HMRC v Thompson [2007] STC 240, the Ch D upheld HMRC's contention that an applicant had not exercised due care and diligence, and this decision has been followed in subsequent cases, such as Marshall v HMRC (TC00849) and Thacker v HMRC (TC02367). However, in this case, the FTT distinguished the decision in Thompson, and rejected HMRC's contention that the appellant had failed to exercise due care and diligence. Judge Radford observed that the appellant had instructed an accountant to deal with his tax affairs, and had been aware that he was paying class 4 NICs. The appellant's failure to understand the difference between class 2 contributions and class 4 contributions did not amount to a failure to exercise 'due care and diligence'.

Dr J Schonfield v HMRC TC2658

Capital Taxes

Intention is important

The taxpayer bought a property with the intention of making it his marital home. He had owned a flat elsewhere but sold that to fund the new purchase. Before completing on the new house, the taxpayer's fiancée broke off the engagement. The taxpayer went ahead with the purchase and moved in his possessions. Three months later, he decided to let the property and live with his parents. It was let from 31 August 2001 to 15 March 2006, when the taxpayer moved in with a view to selling. The house was sold in July 2006.

HMRC assessed the taxpayer to capital gains tax on the gain, saying that the two periods that the taxpayer had stayed in the property had been temporary.

The taxpayer appealed.

Decision:

Describing the case as “extremely finely balanced”, the First-tier Tribunal said that the taxpayer needed to show only that it had been his intention to make the house his permanent residence when he first moved in. It was not the quality of occupation that mattered so much as the occupier's intention. The tribunal accepted the taxpayer's assertion that he had hoped, when he occupied the house, that his fiancée might return. It was clear that, because of an “early repayment charge” clause in the mortgage, it would have been financially unviable for he taxpayer to sell the property straight away. Further, it was understandable that he found the cost of living there on his own was too high and decided to let the property and move back with his parents.

The taxpayer was entitled to only or main residence relief; his appeal was allowed.

Comments – This is an interesting decision as the Court has potentially moved the barrier when examining the quality of occupation in determining whether a property qualifies as a residence when considering the possibility of the principal private residence relief. HMRC would have genuinely believed that the length of time spent in the property was temporary and although the FTT described the case as extremely finely balanced the decision is not the one expected.I

D Morgan TC2596

Entrepreneurs' relief and EMI share options (Lecture P778 – 13.12 minutes)

The EMI scheme provides tax and NIC advantages for qualifying share options granted by companies with gross assets not exceeding £30,000,000 in order to help them recruit and retain key members of staff. As well as the gross assets test, the EMI regime is restricted to companies or groups which are independent and whose trade does not consist of certain excluded activities.

Changes which would allow shares acquired under an EMI option to qualify more regularly for entrepreneurs' relief were first mooted by the Chancellor in his Budget last year. Unfortunately, EMI option-holders, when they acquire their shares, do not often satisfy the 5% shareholding requirement and so any gain on sale is typically charged at a higher rate of tax than 10%. Accordingly, it is now provided that, for shares disposed of on or after 6 April 2013, entrepreneurs' relief will be available to option-holders, regardless of whether or not they meet the 5% test.

However, representations were made last year to the effect that there was little point in the Government doing away with the 5% minimum requirement in these circumstances if they did not also amend the rule which makes it a condition of the relief that the shares must have been owned by the employee for at least one year prior to their disposal. Unlike the position with taper, the qualifying period for entrepreneurs' relief has always started when the shares are acquired (*not* when the EMI option is granted) and, given that the majority of option-holders only exercise their options when they are reasonably certain that a sale is imminent, this means that, even without the 5% test, EMI shareholders would still not be eligible for entrepreneurs' relief.

The legislation published on 28 March 2013 confirms that the one-year holding period for shares acquired under the above arrangements will now be deemed to commence from the date when the option was originally granted (thereby mirroring the hallmark of the old taper relief system). It is welcome news that the Government have listened to feedback from employers and advisers and have responded in this positive way. For 2013/14 onwards, employees holding EMI options for 12 months or more should be able to claim entrepreneurs' relief when they exercise their options and dispose of their shares.

The new rules are set out in Cl 63 and Sch 23 FB 2013.

Regrettably, there is a complication. Because the amended definition of a 'material disposal of business assets' in S169I TCGA 1992 requires the relevant EMI shares to be acquired on or after 6 April 2013, an individual exercising an EMI option during 2012/13 would prima facie not qualify for the improved relief. However, Para 6 Sch 23 states that such shares *can* qualify as relevant EMI shares, despite being acquired before 6 April 2013, but this is subject to two constraints:

(i) if the individual made *no* disposal of such shares in 2012/13, the shares acquired automatically fall within the new arrangements; and

(ii) if any shares of that class *were* disposed of during 2012/13, the individual may elect that the acquired shares are treated as relevant EMI shares – this election must be made by 31 January 2014.

There are changes to the CGT matching rules in Ss105 and 106A TCGA 1992. These are necessary because it is possible for individuals to hold shares in their employer company from both within and outside an EMI scheme. For example, by virtue of new S106A(6A) TCGA 1992, any relevant EMI shares are regarded as having been disposed of in priority to non-EMI shares in the same company and such EMI shares are treated as having been disposed of on a FIFO basis.

Finally, one commentator has summarised the position for companies considering new share option arrangements as follows:

'The timing of option grants in relation to a potential exit will be important. Where EMI options have been granted less than 12 months prior to a proposed exit, entrepreneurs' relief will not be available. The . . . legislation envisages that any shares rolled over as part of a transaction (ie. exchanged for new shares) will fall outside these rules for EMI shares, in which case it will be necessary to satisfy the existing 5% test in order to claim entrepreneurs' relief.

Whilst these changes are welcome for many companies, they do create advantages which are not available to other organisations. For instance, companies backed by private equity are (irrespective of size) not eligible for EMI treatment. Such companies will need different approaches in order to access entrepreneurs' relief for their employees.'

Contributed by Robert Jamieson

IHT deductions for liabilities – the new rules (Lecture P779 – 16.07 minutes)

Background

Measures were announced in Budget 2013 and introduced in Finance Bill 2013 (without warning or consultation) to block the perceived exploitation of the inheritance tax (IHT) rules on liabilities to reduce the value of an estate. Those arrangements (see below) broadly involve obtaining a deduction for a liability and either not repaying the liability after death, or acquiring an asset which is not chargeable to IHT.

The legislation

The IHT legislation concerning liabilities is in IHTA 1984, s 162. Those provisions (prior to the Finance Bill 2013 changes) state:

> "162 Liabilities
>
> (1) A liability in respect of which there is a right to reimbursement shall be taken into account only to the extent (if any) that reimbursement cannot reasonably be expected to be obtained.

(2) Subject to subsection (3) below, where a liability falls to be discharged after the time at which it is to be taken into account it shall be valued as at the time at which it is to be taken into account.

(3) In determining the value of a transferor's estate immediately after a transfer of value, his liability for capital transfer tax shall be computed—

(*a*) without making any allowance for the fact that the tax will not be due immediately, and

(*b*) as if any tax recovered otherwise than from the transferor (or a person liable for it under section 203(1) below) were paid in discharge of a liability in respect of which the transferor had a right to reimbursement.

(4) A liability which is an incumbrance on any property shall, so far as possible, be taken to reduce the value of that property.

(5) Where a liability taken into account is a liability to a person resident outside the United Kingdom which neither—

(*a*) falls to be discharged in the United Kingdom, nor

(*b*) is an incumbrance on property in the United Kingdom,

it shall, so far as possible, be taken to reduce the value of property outside the United Kingdom."

Finance Bill 2013 changes

The Finance Bill 2013 changes introduce conditions and restrictions in the way that a deduction for liabilities is allowed in certain circumstances. The legislation concerning liabilities in s 162 is amended as follows:

- The rule regarding 'incumbrances' in *s 162(4)* only applies after a liability has been taken into account against relievable property under new *s 162B* (ie business or agricultural property, or woodlands), if applicable.
- The rule regarding the liability of a non-UK resident person which neither falls to be discharged in the UK nor is an encumbrance on UK property in *s 162(5)* is subject to the same further condition (see below).

Finance Bill 2013 also introduces new *ss 162A-162C*, which broadly restrict deductions for liabilities attributable to 'excluded' or 'relievable' property.

In addition, a new anti-avoidance rule in *s 175A* restricts deductions for unpaid IHT liabilities following death in certain circumstances.

Restrictions and conditions

The changes introduced by Finance Bill 2013 potentially limit the scope for IHT deductions in respect of liabilities, broadly as follows:

- *Excluded property* - A deduction will not generally be possible for a liability that has been incurred directly or indirectly to acquire, maintain or enhance excluded property for IHT purposes ('excluded property' is broadly non-UK property which is beneficially owned by a non-UK domiciled individual, or settled property situated outside the UK if the settlor was domiciled outside the UK when the settlement was made). However, if the excluded property has been disposed of, or if the liability exceeds the value of the excluded property, a deduction may be allowed if certain conditions are satisfied (*s 162A*).
- *Business property, agricultural property, woodlands* - If the liability was incurred to acquire assets on which an IHT relief for business property, agricultural property or woodlands is due, the liability reduces the value of those assets. The deduction for the liability will be matched against the assets acquired, and relief will be restricted to their net value. Any excess liability will be allowable as a deduction against the estate in general, subject to the new rule below about unpaid liabilities after death (*s 162B*).
- *Liabilities after death* - In working out the value of a person's death estate, a deduction for a liability will only be allowed to the extent that it is repaid to the creditor out of the deceased's estate (and there are no other IHT provisions that prevent it from being taken into account), unless it is shown that there is a 'real commercial reason' for not repaying the liability, *and* it is not left unpaid as part of arrangements to obtain a tax advantage, *and* is not otherwise prevented from being taken into account (*s 175A*).

Implications

The explanatory note to the above measures states:

"The amendments…will remove the tax advantage that arises from obtaining a deduction for a liability and either not repaying the liability after death, or acquiring an asset which is not chargeable to IHT. They will make arrangements which allow 'two bites at the cherry' unattractive because the estate will no longer gain the double benefit of a relief or exclusion and the deduction of a liability."

The types of arrangement potentially affected include:

- Non-UK domiciled individuals with a UK property owned personally, who (prior to the above changes) could borrow money, charge the loan against the UK property, and deposit the borrowings outside the UK as excluded property.

- Loans by employee benefit trusts (EBTs) to beneficiaries, where the EBT trustees write off the loan (and unpaid interest) after the beneficiary's death.

- Investments in 'alternative investment market' (AIM) schemes, where a loan to make the AIM investment is charged against (say) the investor's residence.

Unfortunately, the changes may also affect genuine commercial arrangements, such as business owners who have taken out a loan secured on the family home to invest the proceeds in their business. An effect of the changes is that the loan must be deducted from the value of the business, on which business property relief at 100% may be due, resulting in no IHT deduction for the loan.

Furthermore, the above changes are retroactive. They apply with effect for deaths and chargeable transfers on or after the date on which Finance Bill 2013 receives Royal Assent. Thus liabilities already in existence are potentially affected.

Contributed by Mark McLaughlin

Trustees' exercise of power of advancement: whether invalid

The trustees of two discretionary trusts exercised powers of advancement, with the intention of transferring assets out of the settlements in such a way as to avoid incurring a charge to CGT. However, the trustees and their solicitors had overlooked the provisions of TCGA 1992 s 2(4) (which provides that allowable losses cannot be set off against gains attributed to beneficiaries in specified circumstances).

The trustees applied to the Ch D for declarations that the exercise of the power of advancement had been invalid. Norris J accepted this contention but HMRC appealed to the CA, which unanimously reversed Norris J's decision and held that the exercise of the power had been valid. Lloyd LJ held that an exercise of the power vested in trustees was 'voidable if, and only if, it can be shown to have been done in breach of fiduciary duty'. On the facts here, 'the enlargement and the advancements are not only not void, because they were within the relevant powers of the trustees, but they are also not voidable, because no breach of fiduciary duty was committed in the process of making them'.

Decision:

The Supreme Court unanimously dismissed the trustees' appeal against this decision. Lord Walker held that a court should intervene when trustees had acted in such a way as to amount to a breach of their fiduciary duty. It was not sufficient to show that the trustees' deliberations had fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way. It would be contrary to principle and authority to impose a form of strict liability on trustees who conscientiously obtain and follow, in making a decision which is within the scope of their powers, apparently competent professional advice which turns out to be wrong. On the facts here, the trustees' exercise of the power of advancement had been valid and there were no grounds for the court to intervene.

Comments - The importance of this case is shown by the fact that it was heard by a panel of seven judges, rather than the usual five. Lord Walker delivered a lengthy judgment, with which all six of his fellow-judges agreed. He specifically disapproved obiter dicta of Buckley LJ in of Hastings & Others v CIR (re Hastings-Bass deceased) [1974] STC 211, and obiter dicta of Warner J in the subsequent case of Mettoy Pension Trustees Ltd v Evans [1991] 2 All ER 513. The judgment confirms that it is not as easy to set aside misguided decisions by trustees as some commentators had mistakenly assumed in the aftermath of the Mettoy decision.

Futter & Cutbill v HMRC (Supreme Court)

Application for transfers of assets into settlements to be set aside

An individual (P) suffered serious head injuries in a road accident in 1990. He was rendered permanently incapable of managing his own affairs, and his wife was appointed as his receiver. In 1994, P was awarded substantial damages. On the advice of solicitors, P's wife put these payments into a settlement. The form of settlement gave rise to significant liability to inheritance tax (under IHTA 1984 s 237). P's wife did not discover this until 2003. She applied for a declaration that she should be entitled to unravel the settlement and a related assignment. The CA rejected this contention.

Decision:

The Supreme Court unanimously allowed P's appeal, holding that a voluntary disposition could be set aside on the grounds of equity where there had been a mistake which was sufficiently serious to satisfy the conditions laid down by the HL in Ogilvie v Littleboy (1897) 13 TLR 399. The court was required to make an evaluative judgment as to whether it would be unconscionable or unjust to leave the mistake uncorrected, and form a judgment about the justice of the case. On the facts here, P had an incorrect conscious belief, or made an incorrect tacit assumption, that the proposed settlement had no adverse tax effects. The settlement could have been framed so as to comply with the statutory requirements for relief under IHTA 1984 s 89 without any artificiality or abuse of that statutory relief. It was precisely the sort of trust to which Parliament intended to grant relief under s 89. Accordingly, the settlement should be set aside.

Comments - The Supreme Court heard this case with Futter & Cutbill v HMRC, discussed above, and issued a single judgment covering both cases. However in this case the Supreme Court allowed the appeal, holding that the settlement should be set aside.

Pitt & Others v HMRC (Supreme Court)

Administration

RTI update

Annual Schemes

HMRC has issued guidance reminding employers that, to be considered as annual, a scheme must meet the following requirements:

- all the employees are paid annually;
- all the employees are paid at the same time/same date;
- the employer is only required to pay HMRC annually.

If these criteria are not satisfied, a Full Payment Submission must be made whenever employees are paid, on or before the time of payment. If no payments are made in a particular tax month, HMRC should be informed using an Employer Payment Summary.

If a scheme is registered as annual but more than one FPS is submitted in the year, HMRC will automatically cancel the annual payer status for that year and following years. They will issue a letter to the employer advising the status cancellation and the debt management processes will revert to expecting filing/payment on a monthly basis.

In reviewing requests for a scheme to be treated as annual, HMRC will check the employer's payment history to see whether such a request is appropriate. Employers requesting annual schemes where it is clear that they should be paying HMRC monthly will be considered non-compliant and liable to potential penalties.

Pseudo PAYE schemes

According to the CIoT, HMRC has suggested a pragmatic solution for companies that only have an open PAYE scheme because they reimbursed benefits covered by a dispensation and would otherwise be drawn into submitting a periodic online Employer Payment Summary (EPS) under RTI.

When a company has a live PAYE scheme it is required to report under RTI any payments of wages or salaries made to any employees, even if under the lower earnings limit (LEL) and that employee has not been issued with a coding notice. In addition, when applying online for a dispensation a live PAYE reference is required. However, there is no requirement for a live PAYE scheme to be opened where a company is set up which will never pay earnings, and which, in advance of providing benefits or paying expenses, agrees a dispensation with HMRC. In such cases a request can be made for a ‘pseudo’ employer’s record to be set up in accordance with manual PAYE20070.

Where there is no intention to make wage or salary payments to employees or where all payments will be under the lower earnings limit and no employee has been issued with a coding notice then a ‘pseudo’ employer’s record can also be requested. This means that the employer or agent can apply for an expenses dispensation using the PDF form P11DX and no reports are required under RTI unless an employee’s pay hits the NIC LEL threshold or a PAYE code is issued.

This pragmatic solution should help small companies that often have PAYE schemes purely to obtain the expenses dispensation. The CIoT is investigating whether an existing scheme can be converted into a pseudo scheme.

Short term business visitors - Relaxation of PAYE requirement updated

For employers it may be possible to relax strict PAYE requirements for employees on short-term business visits to the UK. The procedures are set out in PAYE82000 - PAYE operation: international employments: EP appendix 4: criteria for short term business visitors.

From 6 April 2013 the short term business visitor arrangements have been updated.

This arrangement provides that PAYE may be disregarded where:

- individuals are resident in a country with which the UK has a Double Taxation Agreement under which the Dependent Personal Services/Income from Employment Article (Article 15 or the equivalent) is likely to be competent;
- The individuals are coming to work in the UK for a UK company or the UK branch of an overseas company; and
- the duration of their stay in the UK is expected to be 183 days or less in any 12-month period.

In addition, it must be shown that for specifically named employees, the UK company or branch will not in fact ultimately bear the remuneration specified. The arrangement will not apply where the expense of the remuneration is passed on to another UK company or branch and not recharged overseas. Employers who already have signed agreements in place with HMRC do not need to reapply.

Wrong kind of income omitted

The taxpayer's employment was terminated on 31 August 2009. He received a severance payment of £213,600, of which £100,000 was a payment in lieu of notice and the balance was compensation for loss of office. The employer deducted tax at 20% from the total payment, because it had already issued the taxpayer with his P45.

When the taxpayer completed his tax return for 2009/10, he used the figures on the P45 and forgot to include the severance payment.

In January 2012, HMRC crosschecked his return against the employer's return, discovered the discrepancy and wrote to the taxpayer for information. The taxpayer acknowledged the error immediately and explained how it came about. HMRC accepted the taxpayer's explanation and, in view of his co-operation, mitigated the penalty to 15% of the underdeclared tax.

The taxpayer asked HMRC to suspend the penalty, saying he would employ an adviser in future years to ensure careless inaccuracies did not recur, but HMRC refused because it was likely to be a one-off penalty.

The department explained in a letter that, because the taxpayer would probably not receive another severance payment "in the near future", it could not impose conditions to ensure that "careless inaccuracies are avoided in the future", as it could have done had, say, the taxpayer omitted investment income.

The taxpayer appealed.

Decision:

The First-tier Tribunal said that the legislation in FA 2007, Sch 24 had been "drafted deliberately broadly".

The taxpayer had suggested twice that his returns be submitted on his behalf by a professional adviser for the next two years, but on each occasion HMRC failed to "give any indication as to why they considered it did not meet the requirements of the legislation, beyond their blanket statement that 'one-offs' were not appropriate for the suspension regime". There was no evidence to show that they had considered the taxpayer's suggestion at all.

The tribunal found that HMRC's actions were flawed for the purposes of Sch 24 para 17(6). Given that the taxpayer's past compliance record was good and that he would use an adviser to help with future returns, the tribunal ordered HMRC to suspend the penalty.

The taxpayer's appeal was allowed.

Comments – This case demonstrates the key points about the suspension of penalties and the need for them to be considered. The apparent purpose of the legislation was to allow taxpayers the opportunity of a 'last chance' if they mended their ways by taking some specific and observable action which was designed to improve their compliance. HMRC's attitude was therefore wrong and consequently the appeal was allowed.

D Testa TC2549

Duty of care not fulfilled

The taxpayer appealed against penalties for late payment of PAYE during 2010/11. On behalf of the taxpayer, its adviser explained that the company was in financial difficulties, but had done everything it could to save itself from liquidation. It had met all its tax liabilities by borrowing and careful management.

The adviser said that, although insufficiency of funds could not in itself constitute a reasonable excuse, the cause of the insufficiency could. In this case, the cause of the taxpayer's problem was the unexpected loss of one-third of its business and the bank reducing its overdraft and credit facility.

The adviser also said HMRC had not provided the duty of care expected in not warning the taxpayer about the penalties that would be imposed for late payment of its PAYE liabilities.

Decision:

The First-tier Tribunal found that the taxpayer had acted carefully in trying to pay its bills and keep the business going. The judge accepted that HMRC contributed to the taxpayer's lack of awareness about the penalty position by not mentioning it at meetings. He said the taxpayer had "quite genuinely been unaware of the new penalty regime", although that could not be "totally accepted" as a reasonable excuse.

In conclusion, the tribunal decided that, in light of the taxpayer's efforts to overcome its financial problems and the Revenue's failure to warn it about the accumulating penalties, the charges should be cancelled.

The taxpayer's appeal was allowed.

Comments – This case demonstrates the importance of the notification of the new regime and how HMRC had not referred to it in the meetings. Additionally although lack of availability of funds is not a reasonable excuse in the current financial climate the FTT is likely to take it into consideration.

Bale Group Ltd v HMRC TC2568

Reasonable excuse for paper return

A partnership appealed against a penalty for the late filing of its partnership return. It had been filed on paper in January 2012. HMRC said it was late because paper returns were due by 31 October 2011; after that date, returns had to be filed online.

The taxpayer's agent said the earlier deadline was missed because HMRC did not provide the software to cater for the partnership return. The Revenue countered that commercial software was available and that the return made it clear that paper returns had to be filed by 31 October to avoid a penalty.

Decision:

The First-tier Tribunal noted that the tax return states that third-party software must be purchased if the return is to be filed online, although there was no legal obligation to buy software. Was it "unfair, unreasonable or discriminatory to impose an expenditure requirement before the taxpayer is able to satisfy a statutory obligation"? The tribunal believed it was unfair. It was understandable that the government had decided not to produce the relevant software, given that its resources were limited. It was similarly understandable that taxpayers could not afford to purchase the software and that small firms of accountants with few partnership clients made a commercial decision not to buy it.

The tribunal concluded that some partnerships would need the extra time afforded by the online filing deadline to complete their return. HMRC should therefore accept paper returns submitted by 31 January, even though out of time, if a reasonable excuse was given.

The taxpayer's appeal was allowed.

Comments – This represents an unusual decision by the FTT in that they recognised that in the same way as the government had decided not to produce the relevant software, It was similarly understandable that taxpayers could not afford to purchase the software and that small firms of accountants with few partnership clients made a commercial decision not to buy it. Accordingly they recognised this as a reasonable excuse and allowed the appeal.

Paul and Annette Galbraith t/a Galbraith Ceramics TC2639

Payment conundrum

The taxpayer was made in redundant in 2008/09. His pay for the year exceeded £100,000, but the employer incorrectly taxed the sum at 20%. In June 2011, HMRC sent the taxpayer a return for 2008/09, telling him it must be returned within three months. He submitted the return on time, received a tax calculation from the Revenue, and paid the tax due. HMRC imposed a late payment penalty on the grounds that the tax should have been paid by 31 January 2010, as stated on the return. The taxpayer appealed.

Decision:

The First-tier Tribunal quashed the penalty. The taxpayer had not been responsible for the incorrect tax deductions under PAYE, and HMRC's letter sending the return had not specified the due date for payment. This appeared on the return as 31 January 2010, but did not state what it would be if the return was issued late. HMRC failed to communicate effectively when the tax was due.

The taxpayer's appeal was allowed.

Comments – The FTT recognised the fairness of the situation in that a taxpayer cannot necessarily have all the knowledge to be aware of the intricacies of the tax legislation particularly in the circumstances where the tax return is forwarded to the taxpayer much later than the normal circunstances and the special provisions that come into play.

M Styles TC2599

No contact

The taxpayer appealed against penalties for late payment of PAYE for every month in 2010/11.

The managing director of the business said she was not aware of the new penalty system and had not received any warning letters. All correspondence went to her adviser whom she saw for only a few hours each month to deal with the management accounts. She also said she had had no contact with HMRC about late payments and that, if she had, she would have arranged to pay on time. The agent also denied having received any material from HMRC.

Decision:

The First-tier Tribunal accepted the director's statements about the lack of calls from HMRC and that she had no knowledge of the penalty regime. While ignorance of the law did not constitute reasonable excuse, not receiving official material because it had been misdirected did.

The penalties for the first four months were cancelled, but the others confirmed.

The taxpayer's appeal was allowed in part.

Comments - This is another case which demonstrates the importance of the facts in determining whether the taxpayer has had a reasonable excuse. Clearly the Tribunal regarded the lack of receipt of the official material as extremely relevant.

Heirtrace Ltd TC2607

Application for judicial review of HMRC settlement

The case of R (oao UK Uncut Legal Action Ltd) v HMRC (QB) follows on from the widely publicised case of Goldman Sachs International v HMRC (No. 2) [2010] SFTD 930, in which HMRC had issued a ruling to a company (GSI) that the exercise of certain options to employees gave rise to a liability to national insurance contributions. GSI appealed, contending that the staff were supplied by an associated company (GSL), and applied for a preliminary hearing to determine whether it could be treated as the employer of the employees who had exercised the options.

The FTT held a preliminary hearing, reviewed the evidence in detail, and determined the preliminary issue in favour of HMRC, finding that GSL 'did not have a place of business in Great Britain at any time relevant to these appeals', and holding that GSL was a 'foreign employer' within Social Security (Categorisation of Earners) Regulations, SI 1978/1689, r 1(2), with the result that GSI was the 'host employer' within SI 1978/1689, Sch 3 para 9, and was the 'secondary contributor' for the purposes of SSCBA 1992 s 7. GSI appealed to the Upper Tribunal, but the appeal was subsequently settled by an agreement which was strongly criticised by the House of Commons Public Accounts Committee for waiving the interest which was legally chargeable on the unpaid tax.

Another company (UKU) applied to the QB for judicial review of the agreement between HMRC and GSI, contending that the settlement breached HMRC's duty of fairness to the general body of taxpayers.

Decision:

The QB dismissed the application. Nicol J observed that, although UKU had criticised the written evidence given by a senior commissioner of HMRC, it had not applied to cross-examine him. Applying the principles laid down by Stanley Burnton J in R (oao S) v Airedale NHS Trust, QB [2002] EWHC 1780 (Admin), 'it is a convention of our litigation that in general the evidence of a witness is accepted unless he is cross-examined and is thus given the opportunity to rebut the allegations made against him'. On the evidence, Nicol J found that 'the settlement with (GS) was not a glorious episode in the history of the

Revenue. The HMRC officials who negotiated it had not been briefed by the lawyers who were litigating against (GS). They relied on their belief or recollection that there was a barrier to the recovery of interest on the unpaid NICs. That was erroneous. HMRC now accepts that there was no such barrier.' However, 'maladministration and illegality are separate issues', and the settlement had not been unlawful.

Comments - This case has attracted considerable publicity. HMRC responded with a press release which arguably misrepresents Nicol J's decision. Contrary to HMRC's suggestions, Nicol J did not find that HMRC 'made the right settlement in the circumstances', and para 66 of the judgment is critical of HMRC. However, Nicol J found that, although the settlement was open to criticism, it had not been unlawful. Specifically, he observed that although UK Uncut had criticised a witness statement submitted by the former commissioner Dave Hartnett, it had not applied to cross-examine him. Nicol J observed (para 46): 'The claimant could only succeed on this ground of challenge if it had given Mr Hartnett the opportunity to respond in cross-examination. Oral evidence is unusual in judicial review, but it can take place if, exceptionally, the resolution of factual questions is necessary to decide the question of law and oral testimony is necessary for that purpose. It has to be [that the claimant's] case that Mr Hartnett's witness statement which said “the embarrassment and reputation of those individuals was not something we considered relevant to our decision whether to stick with the 19 November settlement” was untrue. Fairness required Mr Hartnett to have the opportunity to answer that allegation orally. In circumstances such as these, in the absence of cross-examination, I could not reach the conclusion which [the claimant] invites.'

R (oao UK Uncut Legal Action Ltd) v HMRC (QB)

Unpredictable problem

The taxpayer received a penalty for late payment of its PAYE and National Insurance in 2010/11. It had been consistently late with such payments in the four years leading up to that year and was aware of the new regime that began in April 2010 for late payments.

The director of the company claimed that it had been badly affected by the recession, with customers paying late and bad debts. A further problem had arisen with an “invoice discounting facility” used by the company. The facility unexpectedly changed its terms, having an adverse effect on the taxpayer. The company claimed it had reasonable excuse for its late payments; it had taken steps to obtain the funds to pay the PAYE, but the inability to pay was caused by events that were unforeseen and out of the company's control.

Decision:

The First-tier Tribunal noted that by the time the new PAYE penalty regime came into force, the impact of the economic downturn was “understood if not manageable”. Companies in the same business as the taxpayer had been badly hit in terms of cashflow, but the tribunal commented that “the makers of the late payment penalty regime were unsympathetic so far as those causes were concerned”.

In this instance, however, the tribunal was satisfied that the taxpayer had done everything “within the bounds of reasonableness” to manage its cash position. The change in the invoice discounting facility could not have been anticipated and should be treated as a reasonable excuse.

The taxpayer's appeal was allowed.

Comments – This is another case where the company in question was able to demonstrate that they had done everything in their power to manage the finances and it is particularly revealing in the comments of the tribunal how potentially unsympathetic the legislators have been.

CUCO TC2550

Special circumstances apply

The taxpayer became ill in June 2010 which led to HMRC accepting his poor health as an excuse for the late filing of his tax return for 2009/10. In February 2011, he had to move into rented accommodation because fire had damaged his home.

He was managing director of a large company which fell into difficulties because of his illness. It went into administration in March 2012. Despite these problems, the taxpayer filed his 2010/11 tax return by 31 October 2011. In November, HMRC sent him a tax calculation. The taxpayer noticed that it contained a number of errors, but did not write to point them out to the department until April 2012. Six months later, agreement was reached on the tax due, but the taxpayer asked HMRC to offset the amount against the tax that he would have overpaid for 2012/13, due to his becoming unemployed as the result of his business failing. He believed that HMRC agreed to this, but they said this was not the case.

HMRC imposed penalties for the late payment of tax for 2010/11, because the tax remained unpaid at 31 January 2012 and 31 July 2012. The taxpayer appealed.

Decision:

The First-tier Tribunal did not accept the taxpayer's excuse that working to keep his business solvent prevented him attending to his own tax affairs until April 2012. It was understandable, but a person could not “in general choose to prioritise his business or job entirely above his obligations to return and pay tax”. There was therefore no reasonable excuse in respect of the first penalty.

As to the second penalty, the tribunal said that ordinarily there was no reason to quash this. Although the taxpayer may have believed that, because he had overpaid tax in 2012/13, it could not be treated as covering the outstanding tax for 2010/11. ITEPA 2003, s 683 and s 684 make it clear that PAYE deductions relate to the current year's tax liability. They cannot be treated as payment for previous year's liabilities.

However, the taxpayer's circumstances were unusual. He had been a high earner whose employment ceased two weeks into the tax year, and he was now on benefits. A large repayment of PAYE would be due for 2012/13 and was likely to exceed the unpaid tax for 2010/11.

The tribunal concluded that the PAYE overpayment could be viewed as special circumstances within the Income Tax (PAYE) Regulations 2003, reg 9. As a result, the penalty should be stayed until the taxpayer's 2012/13 liability was known and, providing this exceeded the tax due for 2010/11, the penalty should be reduced to nil.

The taxpayer's appeal was allowed in part.

Comments – This case demonstrates how a number of circumstances can come together to completely disrupt normal procedures and the importance of the Tribunal being able to take these into consideration. It also demonstrates how the Tribunal will can take the extremes suffered by the taxpayer into account and the fact that overall there was likely to an excess of the repayable amount for one tax year over the amount due in respect of another tax year although in law they were not capable of being set off.

C Horne TC2592

Business Taxation

Relief for R&D expenditure (Lecture B779 – 11.05 minutes)

In computing their taxable profits, small and medium-sized companies are able to claim a special enhanced deduction for qualifying R&D expenditure (see S1044 CTA 2009). Since 1 April 2012, their allowable deduction (often referred to as a 'super-deduction') has been 225% of the relevant expenditure. For a company paying corporation tax at 23%, this represents an effective tax relief of 51.75%.

In order for a company to be classified as medium-sized, it must have:

(i) fewer than 500 employees; and
(ii) either:
– a turnover not exceeding €100,000,000 (roughly equivalent to £85,000,000); or
– a gross assets total in its balance sheet not exceeding €86,000,000 (roughly equivalent to £73,000,000).

In other words, such companies may still be very substantial enterprises.

Any company which does not meet the test in (b) above is classified as large. Large companies enjoy a less generous super-deduction. Since 1 August 2008, this has been set at 130% of their qualifying R&D expenditure.

Following several rounds of consultation (which started in 2010), it has been announced that large companies will now be able to claim a new form of R&D tax relief – this is to be known as an 'above the line' (ATL) credit and will initially be given at 10% (Cl 34 and Sch 14 FB 2013). The increase from the previously announced 9.1% rate was in response to comments received by the Treasury during the consultation process.

The ATL regime can be opted into from 1 April 2013 and will replace the existing super-deduction scheme from 1 April 2016 onwards. However, once a claim has been made under the ATL regime, it is not possible subsequently to return to the old rules. The underlying rules for identifying qualifying activity and calculating qualifying expenditure remain unchanged.

A key feature of the ATL credit is that it will be a taxable receipt and will be paid net of tax to companies with no corporation tax liability. Effectively, it is like a grant. This makes it a more attractive proposition for loss-making companies than the present 130% super-deduction arrangements. Under these, if a large company incurs qualifying R&D expenditure and makes a loss, the effect of the super-deduction is that, in most cases, it simply has a bigger loss to carry forward.

Illustration

Frederick Industries plc is a large company for R&D relief purposes. On the assumption that it has incurred qualifying R&D expenditure of 1000, the comparison below shows the difference between the super-deduction and the ATL systems:

	Current	**ATL**
Turnover	2600	2600
R&D expenditure	(1000)	(1000)
ATL credit		100
Other expenditure	(1200)	(1200)
	400	500
R&D relief (30%)	(300)	
Taxable profit	100	500
CT @ 23%	23	115
ATL credit		(100)
Tax payable	23	15

Contributed by Robert Jamieson

Disincorporation relief (Lecture B776 – 21.41.minutes)

In February 2012, the OTS published various reports relating to small business tax. One of these identified the existence of many businesses operating as limited companies which would much prefer to function as sole traders or partnerships but were precluded from doing so because of a number of tax charges and administrative issues which the OTS highlighted as discouraging such a metamorphosis.

In his Budget last year, the Chancellor announced a consultation based on the OTS proposals for a disincorporation relief. That consultation closed on 30 August 2012 and the Government confirmed that they would like to go ahead with the idea.

The previous legislation required a company to pay corporation tax:

(i) under TCGA 1992 when chargeable gains arose on the disposal of assets from the company; and

(ii) under Part 8 of CTA 2009 when credits arose from the realisation of post-31 March 2002 goodwill,

based on the market value of the assets at the time of the transfer.

A new relief has been introduced with effect from 1 April 2013 which allows a company to transfer qualifying assets at a reduced value to shareholders who wish to continue the business as individuals in an unincorporated form.

More specifically, a claim for relief can be made where:

(i) a company transfers its business to some or all of its shareholders;

(ii) the transfer is a 'qualifying business transfer'; and

(iii) the business transfer date falls within a five-year period starting on 1 April 2013 (Cl 57 FB 2013).

A qualifying business transfer is one where all the following conditions in Cl 58 FB 2013 are met:

(i) the business is transferred as a going concern;

(ii) the business is transferred with all its assets (or all of them other than cash);

(iii) the aggregate market value of the qualifying assets transferred (see (g) below) does not exceed £100,000;

(iv) all the shareholders to whom the business is transferred are individuals; and

(v) each of the shareholders has held his or her shares for a minimum period of at least 12 months ended with the business transfer date.

Note that the relief excludes a transfer to members of an LLP – see Cl 58(7) FB 2013.

A qualifying asset is defined as:
(i) goodwill; or
(ii) an interest in land which is not held as trading stock (Cl 58(10) FB 2013).

It is not clear why the legislation in this regard has had to impose a value cap as low as £100,000.

Any claim for disincorporation relief, which is irrevocable, must be made jointly by the company and all the shareholders to whom the business is transferred within a period of two years from the business transfer date (Cl 59 FB 2013).

The effect of a disincorporation relief claim is that any land and pre-FA 2002 goodwill is transferred for a deemed consideration equal to the lower of:

(i) the cost of the asset to the company; and
(ii) its market value (S162B TCGA 1992).

Where the goodwill arose on or after 1 April 2002, the transfer value is determined under new S849A CTA 2009 as follows:

(i) it is taken as the lower of the goodwill's tax written down value or market value where the asset has been written down for tax purposes;
(ii) it is taken as the lower of the goodwill's cost or market value where the asset was shown in the company's balance sheet and has not been written down for tax purposes; and
(iii) it is taken as nil where the asset has not been shown in the company's balance sheet (S162C TCGA 1992).

It should be noted that this company relief does not cover any tax charges which may arise on the shareholders when assets are distributed to them in the course of a disincorporation.

Illustration
Richard Electrical Ltd is a business which deals with electrical and wiring problems in homes and offices. Profits have been stable at around £20,000 per annum. The company has one shareholder (Richard).

The table below summarises in outline the financial position of the company (S162 TCGA 1992 relief was disclaimed when Richard incorporated his sole trading business):

	Value at incorporation	Current value
	£	£
Goodwill	10,000	40,000
Trade premises	23,000	50,000
Machinery and plant	8,000	14,000
Debtors	4,000	9,000
Cash	5,000	7,000
	£50,000	£120,000

Richard Electrical Ltd is essentially a one-man company with the proprietor, Richard, having difficulty understanding that his company is a separate legal entity. Consequently, there have been tax issues relating to Richard's overdrawn director's loan account and additional annual accountancy fees outweighing any tax savings which had been highlighted to him when he incorporated. Richard would now like to disincorporate.

Assume that Richard's business originally started before 1 April 2002 and was incorporated 10 years ago. The position without disincorporation relief is:

Tax charge on company

		£
Gain on goodwill		30,000
Gain on premises		27,000
		57,000
Less:	Indexation allowance (say):	
	£33,000 x 0.400	13,200
		£43,800 @ 20% = £8,760

Tax charge on Richard with formal winding up

			£
Distribution (120,000 – 8,760)			111,240
Less:	Cost	50,000	
			______
			61,240
Less:		Annual CGT exemption	10,900
			______
			£50,340 @ 10% = £5,034
			______

The total tax bill will be £8,760 + £5,034 = £13,794.

If the company was informally struck off, capital treatment would not be available to Richard because the company's total assets exceed the legislative limit of £25,000 in S1030A CTA 2010 and so an income tax charge would apply. As this would be significantly higher than under the formal winding up route illustrated above, it would not be advisable.

The position with disincorporation relief is:

Tax charge on company

The goodwill and the premises will be transferred to Richard at the lower of cost or market value – in this case, the transfer will be at cost so that no gain arises on the company. It should be appreciated that disincorporation relief simply defers the tax charge on the chargeable assets until such time as Richard's sole trader business is sold.

An election will be made under S266 CAA 2001 for the machinery and plant to be transferred to Richard at tax written down value – this is assumed to be £2,000. The cash will be taken out separately through Richard's loan account (which is no longer overdrawn). There is no corporation tax to pay.

Tax charge on Richard with formal winding up (assets > £25,000)

The disincorporation rules in Ss162B and 162C TCGA 1992 do not provide any relief for shareholder distribution charges. As a result, when the company is wound up, Richard will suffer a CGT charge under the capital distribution rules in S122 TCGA 1992. Richard's chargeable gain would be based on the market value of the assets distributed to him less the CGT cost of his shares.

It would seem that there is a double tax charge, ie. once on the winding up and again, at a later date, when Richard's business is sold.

Contributed by Robert Jamieson

Supreme Court backs M&S on timing of 'no possibilities' test for cross-border refunds

These appeals raise questions about the availability of cross-border group relief and the method of quantifying such relief. These questions arise in respect of claims made by Marks and Spencer plc ("M&S") for group relief in respect of losses sustained by two of its subsidiaries: Marks and Spencer (Deutschland) GmbH ("MSD"), which was resident in Germany; and Marks and Spencer (Belgium) NV ("MSB"), which was resident in Belgium. In March 2001, M&S decided to withdraw from its continental European activity. MSD ceased trading in August 2001 and was dissolved following liquidation on 14 December 2007. MSB ceased trading on 22 December 2001 and was dissolved following liquidation on 27 December 2007. Between 2000 and 2008, M&S made several group relief claims in relation to losses sustained by MSD and MSB. The basic contention underlying all these claims was that the provisions in United Kingdom legislation which restricted group relief claims to losses of UK resident companies and, after the Finance Act 2000, losses of UK branches of nonresident companies, were contrary to article 43 EC (now article 49 TFEU) on the freedom of establishment, and were thus unlawful.

The first claims were originally made and refused by the Revenue ("HMRC") more than ten years ago. The matter came before Park J, who made a reference to the CJEU. The CJEU ruled that article 43 EC did not preclude provisions of a Member State which prevented a resident parent company from claiming group relief for losses incurred by a subsidiary established in another Member State. The CJEU also ruled that it is contrary to articles 43 and 48 EC to preclude the possibility for the parent company to deduct from its taxable profits in that Member State the losses incurred by its non-resident subsidiary where, in one Member State, the resident parent company satisfies two conditions: (i) the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods; and (ii) there is no possibility for the foreign subsidiary's losses to be taken into account in its state of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.

In giving effect to the CJEU's ruling, Park J, with whom the Court of Appeal agreed, held that the "no possibilities" test required an analysis of the recognised possibilities legally available given the objective facts of the company's situation at the relevant time, and that the test was to be applied at the date when the group relief claim was made. On the basis of that approach, the matter then made its way through the Tax Chamber of the First Tier Tribunal, and the Upper Tribunal, before reaching the Court of Appeal. Moses LJ, with whom Etherton and Lloyd LJJ agreed, disagreed with Park J's approach. They considered that the claimant should not be given an opportunity to take steps that might bring about a situation in which it could make a cross-border claim. However, they concluded that they were bound by previous authority and could not depart from it.

In the Supreme Court, four issues arise for consideration. The parties will be heard as to the answers to be given to three of those issues at a later date.

The first of those issues addressed in this appeal concerns whether the CJEU decided it was contrary to article 43 EC to preclude cross-border group relief in the Member State of the claimant company:

(a) only where the taxpayer can show, on the basis of the circumstances existing at the end of the accounting period in which the losses in question arose, that there was no possibility of the losses in question being utilised in the Member State of the surrendering company in that accounting period, in any previous accounting period or in future accounting periods (as HMRC contend); or

(b) where the taxpayer can show, on the basis of the circumstances existing at the date of the claim, that there has been no possibility of utilising the losses in the Member State of the surrendering company in any accounting period prior to the date of the claim and no possibility of such utilisation in the accounting period in which the claim is made or in future accounting periods (as M&S contend).

Judgment

The Supreme Court unanimously dismisses HMRC's appeal and adopts approach (b). Lord Hope gives the judgment of the Court.

Reasons For The Judgment

The exercise to be carried out is essentially a factual one. The claimant company ought to be given an opportunity to deal with it in as realistic a manner as possible. It would hardly ever be possible, if regard is had only to how matters stood at the end of the relevant accounting period, to exclude entirely the possibility that the losses in question might be utilised in the Member State of the surrendering company unless, of course, this was prevented by its local law. The CJEU's judgment in February 2013 in Case-123/11 Proceedings brought by A Oy makes clear that the claimant company is not required to be restricted to such an extent [30]. There is no indication that selecting the date of the claim is likely in practice to give rise to any difficulty. On the contrary, that date has the advantage of certainty, as the facts to be inquired into will not be susceptible to change between the making of the claim and the commencement of the inquiry. The entitlement to cross-border relief is to be examined, as stated in approach (b), on the basis of the circumstances existing at the date of the claim [31].

The national court will, of course, be alert to the possibility that the claimant company may simply be choosing in which Member State it should be taxed. However, what M&S was doing can be attributed to the fact that the companies had ceased trading six years earlier, and not to the exercise of an option to choose where to seek relief for the losses that had been incurred. There is no reason to think that what it did must be seen as a threat to the balanced allocation of taxing powers [32].

Therefore, the question for inquiry is whether the claimant company has been able to show, on the basis of the circumstances known at the date when it makes its claim, that there has been no possibility of the losses in question being utilised in the Member State of the surrendering company in any

accounting period prior to the date of the claim and no possibility of such utilisation in the accounting period in which the claim is made or in any future accounting periods [33].

Construction industry scheme: deductions on account of tax

An English accountant, who lived in the Isle of Man, incorporated a company (O) in 1991. In 1999, O incorporated a subsidiary company (IM). IM began to carry on business in the UK, and to help construction workers to obtain work, but did not register under the construction industry scheme. In 2001, IM incorporated a UK subsidiary (IK), which applied for, and obtained, registration under the scheme. In 2007, HMRC began an enquiry into IK's returns. HMRC subsequently discovered that IK had made substantial payments to IM, and formed the opinion that these had been made for the supply of subcontract labour, and should have been treated as falling within the construction industry scheme. They issued determinations, charging tax of more than £42,000,000, and issued a notice cancelling IK's gross payment status. IK appealed.

Decision:

The First-tier Tribunal reviewed the evidence in detail and dismissed the appeals. Judge Herrington found that IM 'performed a management role in relation to contracts for work entered into by the construction workers within the firms for whom they provided their services'. It acted 'as the construction worker's agent in remitting payments in respect of arrangements entered into by the construction worker for the provision of his services to third parties'. IK had been 'established purely to enable payments to be received gross and to replicate what was previously effected directly by construction firms and agencies with (IM) until it became clear that those entities required to deal with an entity that could receive gross payments'. IK was 'a mere conduit for the passing through of sums it received gross in respect of construction services provided by the construction workers to the construction firms concerned'. For the purposes of the construction industry scheme, IK was a contractor. The payments which it made to IM were 'contract payments', since IM was a 'nominated person' within FA 2004 s 60(1)(c). Judge Herrington concluded that IM had been 'fully aware of the risk that the arrangements may not be compliant with the CIS but deliberately refrained from discussing it with HMRC'. Its actions were 'likely to have resulted in a shocking level of tax evasion and loss of the revenue to the exchequer in respect of sums that should have been accounted for in respect of payments made to the construction workers'.

Comments - There is a substantial amount of money at stake in this case, and the resulting publicity is unlikely to help the public image of the accountancy profession. Judge Herrington's comments are self-explanatory.

Island Contract Management (UK) Ltd v HMRC TC2622

Business entertainment

A UK company invited some of its clients to attend a powerboat grand prix in Tunisia. It claimed a deduction for the cost of this. HMRC issued an assessment disallowing the claim on the basis that the expenditure constituted 'business entertainment'.

Decision:

The First-tier Tribunal (FTT) dismissed the company's appeal against the assessment.

Comments - Inviting clients to a powerboat grand prix was within the definition of 'business entertainment', so that the effect of CTA 2009 ss 1298–1300 was that it was not allowable as a deduction.

Aeroassistance Logistics Ltd v HMRC TC2628

Partnership Consultation

A consultation document has been published on two aspects of the partnership rules which has a closing date for comments of 9 August 2013.

The proposals which were announced at Budget 2013 are directed at:

- removing the presumption of self-employment for some LLP members to tackle the disguising of employment relationships through LLPs; and
- countering the manipulation of profit and loss allocations (by some LLPs and other partnerships) to achieve a tax advantage.

Salaried members of LLPs

Current tax rules mean that individuals who are members of an LLP are taxed as if they are partners in a partnership established under the Partnership Act 1890, even if they are engaged on terms closer to those of employees. The government believes that LLPs are being used and marketed as a means of disguising employment and thus avoid employment income tax and NICs.

The following changes have been proposed:

- remove the presumption that all individual LLP members are treated as partners and hence self-employed for tax purposes; and
- set out the factors which will be taken into account in deciding whether an individual member of an LLP should be treated as an employee for the purposes of employment taxes.

This will be achieved by providing that an individual member who meets either of two conditions will be classed as a salaried member and will be liable to income tax and primary Class 1 NICs as an employee. The LLP will become the secondary contributor and be liable to pay secondary NICs.

The first condition is that a salaried member of an LLP is an individual member of the LLP who, on the assumption that the LLP is carried on as a partnership by two or more members of the LLP, would be regarded as employed by that partnership.

The second condition is that a salaried member of an LLP includes an individual member of the LLP who does not meet the first condition, but who:

- has no economic risk (loss of capital or repayment of drawings) in the event that the LLP makes a loss or is wound up;
- is not entitled to a share of the profits; and
- is not entitled to a share of any surplus assets on a winding-up.

Allocation of partnership and LLP profits and losses

The second area for proposals concern schemes where partnerships allocate profits or losses in order to reduce tax. These schemes often involve partnerships (not just LLPs) where there is a mixture of individual and company members. They relate to all types of partnerships including LLPs,foreign partnerships and entities established in other jurisdictions that are treated for UK tax purposes as partnerships.

The Government's objective is that tax advantages should not arise where there are inappropriate partnership in three distinct types of arrangement:

- Partnerships with mixed members (typically companies and individuals) where profits are allocated to a member that pays a lower rate of tax.
- Partnerships with mixed members where losses are allocated to a member that pays a high rate of tax.
- Partnership arrangements where members reduce their profit entitlement in return for payment made by other members who will be taxed more favourably on those profits.

The proposals do not cover issues 'where family members use partnership structures to allocate profits between them tax efficiently in circumstances such as those considered in the *Arctic Systems* case.'

Cash accounting (Lecture B777 – 12.05 minutes)

Eligibility for the cash basis

Only unincorporated businesses are permitted to use the cash basis. Its use is purely optional and a business will elect to use the basis; when a partnership wishes to use the cash basis the election must be made by the partner responsible for the tax return. The maximum turnover for entering the cash basis will be the VAT threshold – now £79,000 (although Universal Credit claimants can start using the cash basis if their turnover is up to twice the VAT threshold – currently £158,000). (New s 31B(5) of ITTOIA 2005). A time apportioned limit applies to a short accounting period, and where an individual is involved in several businesses, the limit will apply to the total income of all of them.

Once using the cash basis, businesses will be required to leave when their turnover for the preceding year exceeds twice the VAT threshold – currently £158,000. Where a person carries on more than one business, the turnover limits apply to the combined receipts of both businesses.

The following businesses are specifically excluded from using the cash basis (New s 31C):

- Partnerships in which any partner is not an individual
- Limited liability partnerships
- Lloyd's underwriters
- Businesses with a current herd basis election, and
- Persons with a profit averaging election under S221 ITTOIA (farmers and creative artists)
- Businesses which have made a claim under Business Premises Renovation Allowance within the previous seven years
- Businesses carrying on a trade of mineral extraction
- Businesses which still own an asset for which research and development capital allowances have been claimed in a previous period (without limit).

The cash basis

An election to use the cash basis is made under new s25A, and this has effect for the tax year for which it is made, and subsequent tax periods until either the business ceases to meet the financial limits relevant to the scheme, or the circumstances of the business change so that GAAP based accounts are more appropriate and an election out of the cash basis is made. Once the election is made to use the cash basis, this applies to all businesses in which the individual is involved.

Accounts for tax purposes will be prepared based on the income as it is received by the business and the expenditure as it is paid. (new s 31 E) This is subject to a number of special provisions. The legislation provides that expenses may be disallowed by law (as would normally apply), but the following special rules apply specifically to the cash basis.

General rules that do not apply under the cash basis

The following general principles in computing the profits of a business do not apply when the business elects to use the cash basis: (all sections in ITTOIA 2005)

Section 33 – capital expenditure; replaced by new S 33A cash basis : capital expenditure

Section 35 – bad and doubtful debts

Sections 36 and 37 – unpaid remuneration

Section 43 – employee benefit contributions, profits calculated before the end of the 9 month period

Sections 48 to 50B – car hire

New special rules for the cash basis only

The legislation adds new sections to ITTOIA 2005, as follows :

Section 33A – this is a general prohibition on a variety of types of capital expenditure which either would not normally attract capital allowances, or which is provided for by the mandatory flat rate allowance for business motoring. The excluded capital expenditure falls into the following broad headings:

- Land, buildings and fixtures acquired at the same time
- Cars and motorcycles
- Intellectual property
- Shares and securities
- Other businesses
- Investment assets
- Non depreciating assets

This permits expenditure on other assets which would normally attract capital allowances to qualify as incurred.

Section 51A – This prohibits the deduction of interest paid on a loan, but permits deductions under new section 57B. This rather unusually provides that interest and loan arrangement fees of up to £500 may be deducted in a year (on a paid basis) and there is no requirement that the loan is "wholly and exclusively" for the business.

Section 55A – restricts rental payments for capital items to those that would obtain a deduction if the capital cost of the item were incurred (thus excluding hire of cars and motorcycles), and in relation to the use in the period or within 3 months after the end of the period (which allows rental payments quarterly in advance, but no more).

Section 94B – this section allows a deduction for payments of VAT which are incurred wholly and exclusively for the purposes of the trade.

Section 96A - Mixed use of a capital asset which is eligible for deduction under the cash basis rules requires the business to account only for the business element – and where the proportion of use changes to treat any reduction in business use as the sale of part of the asset at current market value.

Section 97A – trading stock at cessation to be valued on a just and reasonable basis and included as a receipt

Section 106A – refunds and other payments of VAT to be treated as a receipt from the trade

Section 106B - Refunds of rental payments in respect of assets treated as income of the trade

Other implications of using the cash basis

<u>Losses</u>

There is no relief for losses under the cash basis other than carry forward against future profits of the same trade. Both sideways relief in the year and carry back (including opening year loss relief provisions) will not apply to cash basis users.

<u>Arm's length basis</u>

There is also a requirement that all amounts taken into account are based on an arm's length amount, and adjustments will be required if a transaction is not at arm's length, subject to some minor exclusions.

<u>Goods for own use</u>

Budget 2013 included an announcement that goods for own use must be subject to an adjustment on a "just and reasonable" basis.

Transitional rules

The accounting rules adjusting from the accruals basis to the cash basis, and vice versa essentially use the existing legislation for a change of accounting basis in s 227 ITTOIA 2005. This provides for the computation of adjustment income or an adjustment expense by comparing the items accounted for under the old and the new basis. Where a business leaving the cash basis generates net adjustment income, this may be spread over the subsequent six years (new s 239A). There are also transitional rules covering capital allowances.

Analysing your client's position

Since cash accounting is easier than using GAAP, it is likely to be attractive to new businesses, but it is important to remember that the design of the cash accounting scheme is aimed at the unrepresented taxpayer, who would probably account on a cash basis in any event.

Fee considerations

In terms of both new and existing businesses seeking support from a professional firm, the time saved (and therefore fee reduction) in not computing debtors, prepayments and accruals is likely to be minimal. With businesses of this size and type the main element of the fee is likely to be balancing the bank and checking deductibility of expenses. There is therefore no particular fee saving in offering cash accounting as an option for clients. For most businesses of this size, it is also unlikely that a formal stocktake is carried out, and therefore once again the fees saved by not counting stock are minimal.

Timing differences

Where a business moves on to cash accounting, it is likely that there will be a deferral of tax, as debtors and unbilled work in respect of services will be excluded. However, over the life of the business, the transitional rules will ensure that all profits are taxed once and once only, so any deferral now will unwind in the future. Although the main direct tax rates are probably pretty stable, it is worth remembering that governments have turned to NIC when seeking additional direct tax revenues over the last few years.

Arguably a deferral might prevent a trader from paying higher rate tax in one year, to unwind at basic rate, but as the profits are unlikely to be predictable, and the threshold for higher rate tax is to continue to fall for at least one more year, this would be a risky proposition if offered as a potential saving for the cash basis.

Losses

The restriction of loss relief to carry forward only is a key disadvantage of the cash basis. In a period in which there is substantial investment in capital assets, the losses generated by the allowance (or indeed the parallel AIA for non-cash businesses) are not available to set against the previous year's profits (as a minimum). This is an important downside of the cash basis.

Interest restriction

Restricting deductible interest to £500 irrespective of the balance on capital account is a potential major disadvantage which should be looked at in detail to assess whether it presents an issue for your client.

Summary

Given that the cash basis has been developed to meet the needs of unrepresented taxpayers, it offers little benefit to those clients who already have a professional adviser. After considering the above points, the adviser will probably have no hesitation in recommending that the client continue with full accruals based accounts.

Contributed by Rebecca Benneyworth

VAT

Associated persons

The European Commission applied to the CJEU for a ruling that, by permitting non-taxable persons to be members of a VAT group, the UK had failed to comply with its obligations under art 11 of Directive 2006/112/EC.

Decision:

The CJEU rejected the Commission's contentions, holding that 'the Commission has not established that the objectives of [art 11] of the VAT Directive militate in favour of an interpretation according to which non-taxable persons cannot be included in a tax group'.

Comments – The CJEU has decisively rejected the Commission's view that permitting non-taxable persons to be members of a VAT group contravenes art 11 of Directive 2006/112/EC. The decision here was widely expected, in view of the Commission's earlier decision in a similar case involving the Republic of Ireland (see 'Cases', Tax Journal, 19 April).

European Commission v UK (CJEU Case C-86/11)

Scope of option to tax land

A company (E) had acquired a large site, adjoining a dual carriageway, in 2007. The site included a petrol station, and several warehouses and offices. E advised HMRC that it had made an option to tax the site. In 2011, HMRC formed the opinion that E had failed to account for VAT on rental income from several buildings which it had opted to tax, and issued an assessment. E appealed, contending that in 2007, four weeks after its initial letter to HMRC, it had sent a further letter stating 'option to tax to be limited to area etched red on enclosed plan, excluding buildings etched blue'.

Decision:

The First-tier Tribunal accepted E's evidence and allowed its appeal. Judge Gort found that 'it was quite clearly not (E's) intention to opt to tax the buildings outlined in blue on the Land Registry document' and that it was more likely that the letter had been lost by the Royal Mail or by HMRC than that it was never posted.

Comments - This case demonstrates the importance of clearly indicating the precise area of land which is covered by an option to tax. The First-tier Tribunal accepted the company's contention that its option had covered a smaller area than HMRC had assumed, and had not been intended to extend to certain buildings which it let to tenants.

Exeter Estates Ltd v HMRC TC2632

Recovery of payments from defaulting members

A company (E) operated a chain of fitness clubs. It required new members to join for a minimum of 12 months. In some cases, members failed to make the agreed 12 payments. Such members were barred from using E's facilities within five days of failing to make an agreed payment, and E arranged for debt collection agencies to recover the outstanding amounts. Initially E accounted for VAT on these payments, on the basis that they were taxable consideration for supplies of membership services. Subsequently, it submitted a repayment claim on the basis that, while it accepted that output tax was payable for the five-day period before access was barred, it should have treated the balance of the payments as non-taxable compensation for breach of contract.

Decision:

The Upper Tribunal upheld HMRC's rejection of the claim, holding that 'the payments were consideration for supplies of services by (E), namely the grant of the right to enter the premises of the club and to use the facilities and services provided there, subject to availability. That analysis does not change where the right to enter the club and use its facilities is denied because the member has failed to pay part of the membership fee on time but such fees are paid later.'

Comments - As was widely expected, the Upper Tribunal has reversed Judge Khan's decision and has upheld HMRC's view that the payments which the company received were consideration for supplies of membership services.

HMRC v Esporta Ltd (Upper Tribunal)

Management services supplied to employer's pension fund

Advocate General Sharpston expressed the opinion that 'a taxable person who has established a pension fund as a separate entity for legal and fiscal purposes, in order to safeguard the pension rights of his employees and former employees, may not deduct the tax which he has paid on services supplied to that fund in connection with its management and operation. Such tax may be deducted only by the fund itself, from any tax which it is liable to pay on its own taxable transactions. An investment fund pooling the assets of a retirement pension scheme is not a special investment fund within the meaning of art 13B(d)(6) of Directive 77/388, management of which may be exempted from value added tax in the light of the objective of that directive and the principle of fiscal neutrality, where the members of the scheme do not bear the risk arising from the management of the fund and the contributions which the employer pays into the scheme are a means by which he complies with his legal obligations towards his employees.'

Comments - The Advocate General expressed the opinion that an employer could not deduct input tax relating to supplies made to a pension fund which it had established.

PPG Holdings BV v Inspecteur van de Belastingdienst (CJEU Case C-26/12)

Manufacturing company: purchase and maintenance of helicopter

A company (J), which manufactured vehicle parts, reclaimed input tax on the purchase and maintenance of a helicopter. HMRC issued an assessment to recover the tax, considering that the helicopter had been purchased for the private use of J's controlling director, who was an experienced helicopter pilot. J appealed, contending that it had used the helicopter for business travel and had also hired it to a customer.

Decision:

The First-tier Tribunal accepted J's evidence and allowed its appeal, finding that it had acquired the helicopter 'with a view to making supplies wholly for business purposes'.

Comments - HMRC formed the opinion that the company had acquired the helicopter for the personal use of its controlling director. However, Judge Kempster accepted the company's contention that it had acquired the helicopter for business purposes, and was entitled to credit for the whole of the input tax.

JNK 2000 Ltd v HMRC TC2635

Supplies of services by solicitor: whether book entries constituted payment

A solicitor (R) provided intermediary services for prospective purchasers of capital redemption bonds. He did not account for tax on such supplies, treating them as exempt. HMRC issued an assessment charging tax on the basis that the supplies failed to qualify for exemption and that certain entries in R's books constituted payment of the supplies. R appealed, contending as a preliminary point that the book entries did not constitute payment.

Decision:

The First-tier Tribunal accepted this contention and allowed the appeal (without deciding the substantive issue of whether the supplies were taxable or exempt).

Comments - In Pentex Oil Ltd v C&E Commrs (VTD 7989), a holding company had made supplies to two subsidiary companies, the value of which was recorded by credit and debit entries in the companies' books. The VAT Tribunal held that the supplies were within what is now VAT Regulations, SI 1995/2518, reg 90(1), and that the time of supply was when the entries were made in the companies' books, on the grounds that 'payment may be made by offsetting a debt owed against a debt due, e.g. by journal transfer between purchase and sales ledger accounts, or by making a credit entry in an inter-company current account having a debit balance' and that the time of payment was 'the date on which the appropriate entry is made in the accounting records'. HMRC sought to apply the principles established in Pentex to the facts here, but Judge Kempster distinguished the Pentex decision and held that the book entries did not constitute payment. (For a discussion of when book entries do constitute payment, see De Voil Indirect Tax Service, para V3.133). Judge Kempster's decision also discusses the time limits for the making of an assessment, although the relevant facts with regard to the assessment under appeal

do not appear to be clearly set out in his decision. It is understood that HMRC intend to appeal to the Upper Tribunal against Judge Kempster's decision.

M Reid v HMRC TC2655

'Spot the ball': whether a game of chance

A partnership and several companies, which had accounted for VAT on takings from 'spot the ball' competitions, submitted repayment claims, contending that they should have treated the takings as exempt. HMRC rejected the claims.

Decision:

The FTT allowed the appeals in principle, holding that 'spot the ball' was a game of chance within VATA 1994 Sch 9 Group 4 Note 2(c).

Comments - There is a great deal of money at stake in this case. VATA 1994 Sch 9 Group 4 provides that the provision of facilities 'for the playing of any games of chance' is exempt from VAT. At first sight, one might assume that 'spot the ball' contains a sufficient element of skill to prevent it from qualifying for exemption. However, Judge Poole accepted the appellants' contention that 'spot the ball' was a 'game of chance' so that they were not required to account for VAT on their receipts. HMRC has appealed to the Upper Tribunal against this decision.

The 'Spotting the Ball' Partnership v HMRC (and related appeals) TC2624

Too restricted

The taxpayer was a director of a retirement park containing static caravans for older people. He obtained planning permission to knock down and rebuild a bungalow on the site. Instead of doing this, he bought the adjacent paddock and received planning permission to build a new house there. Permission was given subject to the condition that occupation of the property was limited to a person who worked or had worked at the retirement park.

The taxpayer applied to HMRC for repayment of VAT incurred on the building under the DIY scheme. HMRC refused because of the restricted use clause which did not satisfy VATA 1994, Sch 8 group 5 note 2(c). The taxpayer appealed.

Decision:

The First-tier Tribunal agreed that the clause meant the property failed one of the tests for the DIY scheme to apply. The wording of the permission at the time of the build was relevant, regardless of the fact that the taxpayer had now applied to have the condition removed.

The taxpayer's appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, notes that the conditions of a "dwelling" specified in the legislation must all be met for a building to qualify as such and be eligible for a DIY claim. He says that "developers and their advisers should consider the conditions for a successful DIY VAT claim at the beginning of a project rather than when the building has been completed".

R Drummond (TC2456)

Fee is VATable

The taxpayer was an internet-based retailer that charged customers £19.95 a month for the right to purchase goods at a discount. HMRC said that the fee was subject to VAT at the standard rate. The taxpayer appealed, saying that it was in effect part of the consideration for a supply of goods. If no purchase was made in a month, the fee remained chargeable but the customer received an exempt account management service.

Decision:

The First-tier Tribunal found that the fee was not part payment for goods. The fee was the same regardless of whether the customer bought any item in a month. It was consideration for the right to buy goods at a reduced price.

The taxpayer's appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, said: "The key point is that the nature of a supply is what counts in determining the VAT liability of any payments received, even if a contract or invoice seeks to use alternative phrases to change the VAT position. The nature of the supply in this case appeared to be very clear, ie the right for subscribers to buy goods at discounted rates. These rates were not available to non-subscribers."

Nettexmedia.com Ltd (TC2470)

Selling e-services abroad – with Budget 2013 date (Lecture B780 – 14.32 minutes)

Five categories of income

In general terms, a supply or source of income can be allocated to one of five different categories as far as VAT is concerned:

1. *Standard rated supply* – VAT is due at 20%, the current rate in the UK
2. *Lower-rate (or reduced rate) supply* – currently 5%
3. *Zero-rated supply* – VAT is still being charged on a zero-rated supply of goods or services but at the rate of 0%. The business making the sale can claim input tax on its related expenses.
4. *Exempt supply* – a business does not have to charge VAT on an exempt supply – an exempt supply of goods or services is not classed as taxable. A business that only makes exempt supplies does not need to register for VAT and cannot claim input tax. It is only the taxable supplies made by a

business that count as far as VAT registration is concerned (i.e. standard rated, reduced rated and zero-rated supplies).

5. *Outside the scope or non-business income* – in this situation, **no supply of either goods or services is being made in the UK**. Again, any business that is only receiving income that is outside the scope of VAT does not need to worry about registering for VAT. Many services supplied to an overseas customer are outside the scope of UK VAT because the place of supply is where the customer is based or, in some cases, where the work is performed. Note - a business that solely makes supplies which take place outside the UK but would be taxable if supplied in the UK can register voluntarily and is able to claim back relevant input VAT.

Example 1

Hot Music Ltd supplies music downloads over the Internet for £1 per song. Customers are all private individuals i.e. non-business customers (B2C) and are located throughout the world. The company is not VAT registered and its annual income split is as follows:

- UK based customers - £40,000
- EU based customers outside UK - £20,000
- Non-EU based customers, mainly USA - £30,000

The place of supply for ‘electronic services’ to a non-EU customer is based on the location of the customer i.e. where he or she is resident.

VATA1994, Sch4A, para 16(2)(k).

Sales to customers outside the EU are outside the scope of UK and EU VAT. Hot Music Ltd will need details of the names and addresses of its customers in such cases to support the non-VAT charge to these customers (if Hot Music Ltd had been VAT registered) or the exclusion from taxable turnover as the company is not VAT registered.

The company is not required to register for VAT. Taxable income is £60,000 (UK and EU customers) which is below the compulsory registration threshold of £79,000. It can register for VAT on a voluntary basis.

Note – in situations such as those above, a useful reference point regarding the customer’s country of residence is HMRC Notice 741A, para 19.3 (How do I identify my customer's country of residence?)

Basic ‘place of supply’ rules (the ‘general rule’)

1 January 2010 and 2011 were the two big dates in the place of supply calendar, which created two general rules that will apply in most cases:

- If a UK business is selling a service to an overseas business customer (B2B sale) then no UK VAT is charged because the place of supply (country where VAT is payable) is where the customer is based. This principle applies irrespective of whether the customer is in the EU or otherwise. If the customer is in the EU, and assuming the service in question is ‘taxable’ in that country, then the customer will deal with the VAT on his own return by doing a reverse charge calculation.

- If a UK business is selling a service to an overseas customer who is not in business (B2C sale) then the place of supply is UK and we charge the same rate of VAT on our invoice to the customer as we would if we were invoicing someone in Nottingham.

Example 2

John is a VAT registered management consultant based in Leeds and raises a sales invoice to Berlin Ltd based in Germany for some work he carried out from his UK offices. John's sale is outside the scope of VAT – the place of supply is Germany. He records the sale in Box 6 of his VAT return (outputs) and also includes it on a quarterly EC Sales List (calendar quarter basis).

The German customer will apply the reverse charge calculation and declare output tax in Box 1 of his VAT return (value of invoice multiplied by German rate of VAT i.e. 19%) and claim the same amount back as input tax in Box 4 assuming the business is not exempt or partly exempt and the service is not partly used for non-business or private purposes. The customer also records the net amount of the invoice in both Box 6 and Box 7 (outputs and inputs) but a zero entry is relevant to both John and Berlin Ltd for Box 8/9 because the sale is for services and not goods (see next page for VAT return boxes).

Example 3

John from Example 2 completes some work for a charity in Italy that does not make business supplies. This is a B2C sale covered by the general rule, so John charges 20% UK VAT to the customer, even though the charity is based outside the UK.

Note - going back to Example 2, don't think that that a B2B overseas sale in this situation is 'zero-rated' or 'exempt'. It is not.....'consultancy' services are not listed in VATA1994, Sch. 8 or 9 (the zero-rated and exemption schedules in the legislation) – the service is outside the scope of VAT if the customer is in business and based outside the UK.

Note – reminder of Boxes on VAT return

Box 1 – output tax

Box 2 – acquisition tax

Box 3 = Box 1 + Box 2

Box 4 – input tax

Box 5 = VAT payable i.e. Box 3 – Box 4

Box 6 – outputs

Box 7 – inputs

Box 8 – EU dispatches of goods

Box 9 – EU acquisitions of goods

Customer outside EU - VATA1994, Sch. 4A, para. 16

So let's look at some of the exceptions to the general B2B and B2C rules. The first good news is that if a service is listed in the above piece of legislation, then it is also outside the scope of VAT in the case of a B2C sale (as well as a B2B sale) if the customer is based outside the EU. I have highlighted the more common services in bold text.

- **Box 4 – services outside the scope of UK VAT if supplied to a non-EU based customer – VATA1994, Sch. 4A, para. 16(2) – (a) to (k)**
- transfers and assignments of **copyright, patents, licences, trademarks and similar rights**
- the acceptance of any obligation to refrain from pursuing or exercising (in whole or in part) any business activity or any rights within the above paragraph
- **advertising services**
- services of **consultants, engineers, consultancy bureaux, lawyers, accountants and similar services**; data processing and provision of information (excluding any services relating to land)
- banking, financial and insurance services (including reinsurance), other than the provision of safe deposit facilities
- the provision of access to, and of transport or transmission through, natural gas and electricity distributions systems and the provision of other directly linked services
- the supply of staff
- the letting on **hire of goods other than means of transport**
- telecommunications services
- radio and television broadcasting services
- **electronically supplied services**

Note – in the case of the final four 'bullet point' categories, a UK VAT charge would still apply if an overseas resident was 'enjoying' the services in the UK.

Example – an American tourist hiring a camera to use on his UK holiday. Equally, a UK VAT charge would not apply if a UK resident acquired the service in question from a UK supplier but with the intention of 'enjoying' the service outside the EU.

Full details about the above services can be found in HMRC Notice 741A, section 14. Here are a couple of practical tips:

- You need to hold evidence or some record that the customer is genuinely based outside the EU. It is not sufficient to rely on an email address such as john@newyork.com. You will need details of the residential address of the customer.

- If you can't obtain assurance that your customer is resident outside the EU, then the default general B2C rule will apply i.e. 20% VAT will be charged if the supply is taxable.

Box 5 - HMRC Notice 741 – section 14.3.1 Example of a supply of services supplied outside the EC

If you supply accountancy services to a private individual who belongs in the Channel Islands, the place of supply of your services is outside the EC. This is because your customer belongs outside the EC. You should not charge VAT.

Example 4

I had an interesting query from a client recently concerning advertising income he was earning from his website. Do I charge VAT or not if the customer is based outside the UK, he asked?

The good news is that he will not charge VAT on any adverts taken out by business customers based outside the UK (general B2B rule) and also any adverts taken out by B2C customers based outside the EU (VATA1994, Sch4A, para. 16(2)(c)). But any UK based customer or non-business customer in the EU will be charged 20% VAT.

Important changes to B2C rules – 1 January 2015

Legislation will be introduced in Finance Bill 2014 to tax intra-EU business to consumer (B2C) supplies of the following services according to the EU country (Member State to quote the phrase used by HMRC) where the customer is located:

- telecommunications services
- broadcasting services
- e-services

These services are currently taxed in the country in which the business is established. The changes will take effect from 1 January 2015 and implement already agreed EU legislation into UK legislation, ensuring that these services are taxed fairly in the Member State of consumption.

Example 5

Music Ltd is based in the UK and sells music downloads to a range of customers in different EU countries – the customers are all private individuals i.e. non-business customers (B2C). Until 31 December 2014, the place of supply is UK for these services, and subject to 20% VAT, assuming Music Ltd is VAT registered or liable to be registered. From 1 January 2015, the supply will be subject to VAT based on where the customer is located – so a customer in France will be charged 19.6% French VAT by Music Ltd, and this tax will need to be declared to the French tax authorities. The income received will be outside the scope of UK VAT – the place of supply is France.

Will a UK business covered by the new rules need to VAT register in each different EU country where it has B2C customers?

To save the need for businesses affected by these changes having to register for VAT in other Member States, a Mini One Stop Shop (MOSS) will also be introduced from 1 January 2015. This is an IT system that will give businesses the option of registering in just the UK and accounting for VAT due in other EU countries using a single return.

Will there be scope for a business in some cases to deregister from UK VAT?

If the end result is that a UK business has taxable sales below the deregistration limits (considered in the previous section), then it will be able to deregister and save accounting for 20% VAT on its UK sales with effect from 1 January 2015. The following example considers how this will work in practice:

Example 6

Music Ltd from the previous example has total sales of £90,000 (excluding VAT) selling downloads of music to its customers (all private individuals) and has no other sources of income:

- £70,000 to UK based customers
- £20,000 to French based customers

With effect from 1 January 2015, taxable sales in the UK will be £70,000 (assuming no change in trading factors etc) i.e. below the deregistration threshold because the French sales will be subject to French VAT. However, the issue for the company will be how it deals with prices charged to the UK customers – if it leaves prices unchanged (i.e. no price reduction is given to customers to reflect the fact that UK sales will be free from VAT), then its actual expected UK sales in the next 12 months will be £84,000 (£70,000 plus £14,000) which is not less than the deregistration threshold. A sensible outcome would be to reduce prices by say 10% i.e. to share the VAT saving with a customer and at the same time give expected UK sales of £84,000 x 90% = £75.600 which is below the deregistration threshold.

When will an affected business be able to register for MOSS?

Answer - October 2014 i.e. well in advance of 1 January 2015. MOSS avoids the need for a business having to register in each EU country where it sells electronic services (and also in relation to broadcasting and telecommunications services) to non-business customers. I suppose the downside of a MOSS arrangement is that if the UK business pays overseas VAT for any reason (although most services purchased from another EU country will avoid domestic VAT under the general B2B rule), then it has a source of input tax recovery with the separate VAT return in the country in question. With the MOSS system, the route to claim any overseas VAT would be through the overseas VAT repayment claim system, which tends to be more laborious - and certain countries do not have a good track record of settling claims.....mentioning no specific examples!

What exactly are telecommunications, broadcasting and e-services?

HMRC intend to give full details about what services belong to each category (for example, an accountant sending a tax return or set of accounts to clients in electronic format is still providing accountancy/tax services rather than electronic services – he has just communicated to the client by an electronic method rather than by a hard copy letter in the post) – but here is an opening steer from their early guidance:

Telecommunications services – include: fixed and mobile telephone services; videophone services; paging services; facsimile; telegraph and telex services; access to the internet and worldwide web

Broadcasting services – include: radio and television programmes transmitted over a radio or television network; and live broadcasts over the internet

E-services – include: video on demand; download applications (or 'apps'); music downloads; gaming; e-books; anti-virus software and on-line auctions.

Contributed by Neil warren