Tolley®CPD

October 2013

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Personal Tax

Actors' payments are salary

In April 2009, HMRC ruled that actors engaged by ITV, the taxpayer, under certain types of contract were to be treated as employed for National Insurance purposes and that ITV was liable to secondary class 1 National Insurance on their earnings under Social Security (Categorisation of Earners) Regulations 1978 (SI 1978/1689), Sch 1 para 5A(d), as amended by Social Security (Categorisation of Earners) Regulations 1998.

HMRC's decision applied to ten different types of contract used by ITV. Six of those contained a term which entitled the actor to receive an attendance day payment to cover post-synchronisation sessions after filming had been completed. Three contracts included a right to production day payments at a fixed rate for each day worked beyond the first. The remaining "all rights contract" required the actor to attend filming on specific dates, for which a fee was paid.

ITV appealed to the First-tier Tribunal which held that, apart from actors engaged under the "all rights contract" who were not employed earners, payments made under the other contracts were salary, and therefore subject to employers' National Insurance, because they were calculated by reference to the total number of days the actors were "on call", and being on call was work.

The Upper Tribunal upheld that decision, so ITV appealed to the Court of Appeal.

Decision:

The Court of Appeal said the condition in para 5A(d) would be satisfied if the payments due to the actor were made by reference to the time for which work was to be done. The court held that an actor was only working when performing, and that payments calculated by reference to the days on call were not therefore salary. However, it agreed with the previous tribunals that apart from the "all rights contracts", the possibility of post-synchronisation payments constituted salary, and the wording of the contracts to be "inclusive" of daily rates on performance days also made them salary. ITV was therefore liable to pay secondary class 1 National Insurance on them.

The taxpayer's appeal was dismissed.

Comments - Taxation commented that it only takes one element of salary within the payment to "taint" it all. However, the case indicates that minor changes, such as a further lump sum for post-synchronisation work if needed, and saying that the contract "replaced" the daily rates otherwise payable, could well have taken the contracts outside the scope of National Insurance.

ITV Services Ltd v CRC, Court of Appeal

In work or not?

The taxpayer began employment with M, a respondent along with HMRC, in June 2010. In September, the taxpayer fell ill and could not go to work. He obtained sick notes from his GP which he passed to the employer. He did not receive any sick pay so he contacted HMRC.

The employer claimed that it had terminated the taxpayer's employment on 20 September and that it therefore had no liability to make statutory sick payments to the taxpayer. The taxpayer denied this. He said he had neither received any email terminating his employment, nor a P45. Furthermore, if he had no longer been employed, he would have claimed incapacity benefit rather than statutory sick pay. HMRC accepted the employer's version of events and confirmed to the taxpayer that he was not entitled to statutory sick pay.

Decision:

The First-tier Tribunal said evidence existed that the taxpayer's employment continued beyond 20 September, for example, he presented a letter dated 21 October 2010 in which the employer refers to the taxpayer as a "work colleague". No P11 or P45 had been submitted by the employer and these would have had to be submitted to the local tax office if the employment had ended.

It was not disputed that the taxpayer was employed until 20 September and it had to be presumed that his contract continued until the employer could establish otherwise. No substantiated evidence was submitted by the employer and so the taxpayer was entitled to statutory sick pay.

The taxpayer's appeal was allowed.

Comments – When principles are disputed the quality of the evidence to demonstrate the argument is critical. In this case the principle was amply demonstrated with the evidence submitted in addition to the lack of the forms that would normally demonstrate the counter proposition namely the P45 which would have been submitted by the employer.

S McGregor v HMRC TC2748

State pension obtained

The appellant, Mrs Brown, appealed against HMRC's decision that she had been liable to pay married women's reduced rate of National Insurance contributions between 1975 and 1988. As a result of this decision, she was prevented from qualifying for home responsibilities protection (HRP) and consequently was not entitled to a full state pension.

Decision:

The tribunal noted that when the National Insurance scheme was introduced in 1948, there were restrictions on the entitlement of married women to pay contributions. Employed married women were

liable to pay Class 1 contributions unless they elected not to and a self-employed married woman was not liable to pay Class 2 or Class 3 contributions unless they elected to do so.

From April 1975, married women who had previously chosen not to pay became liable to pay married women's reduced rate contributions and until 11 May 1977 a married woman could elect to pay the reduced rate. After that date such an election was no longer possible.

In this case, there were contradictory accounts of how the continuing entitlement to pay the reduced rate had come about and little supporting evidence. Ultimately, the tribunal accepted Mrs Brown's version of events because she had not been working between her marriage in 1968 and returning to work in 1984 after she had brought up her children. Because of the break in employment, there was no lawful way in which the reduced rate should have been allowed to continue by HMRC. Mrs Brown had to pay the difference between reduced rate and full contributions for the period 1984 to 1998, but would be entitled to HRP and an increased state pension.

Comments – When cases involving actions that were or were not taken in respect of NICs particularly with the actions of many years ago and the complexities the importance of correct records is demonstrated. As mentioned the contradictory accounts meant that ultimately the Tribunal had to weigh up the evidence provided by Mrs Brown and thus decided in her favour.

Janet Smith Brown v HMRC TC2705

Copyright royalties received by trustees: rate of tax

A company (C) produced a stage musical in 2004, based on a children's book written in the 1930s. From 2004/05 to 2008/09, copyright royalties from the musical were paid to the trustees of a settlement created on the death of the author of the book (T). The trustees submitted tax returns on the basis that these royalties were only liable to the basic rate of income tax. HMRC issued a ruling that these royalties were taxable at the higher rate applicable to trust income, by virtue of what is now ITA 2007 s 479. The trustees appealed.

Decision:

The First-tier Tribunal allowed the appeal in part, holding that the effect of Law of Property Act 1925 s 164 (which has subsequently been repealed) was that these royalties were taxable at the higher trust rate, insofar as they derived from an exclusive copyright licence which T had granted to C two years before her death, but not insofar as they derived from a later assignment of the relevant copyright by the trustees.

Comments - The First-tier Tribunal upheld HMRC's contention that royalties deriving from a licence granted by the late Mrs Travers (author of the Mary Poppins books) were liable to tax at the higher trust rate. However, the tribunal held that the majority of the royalties, which derived from a subsequent assignment of the copyright by the trustees of her will, were only liable to income tax at the basic rate.

Trustees of the Mrs PL Travers Will Trust v HMRC TC2830

Company cars - advisory fuel rates from 1 September 2013

These rates apply to all journeys on or after 1 September 2013 until further notice. For one month from the date of change, employers may use either the previous or new current rates, as they choose. Employers may therefore make or require supplementary payments if they so wish, but are under no obligation to do either.

Engine size	Petrol	LPG
1400cc or less	15p	10p
1401cc to 2000cc	18p	11p
Over 2000cc	26p	16p

Engine size	Diesel
1600cc or less	12p
1601cc to 2000cc	15p
Over 2000cc	18p

Hybrid cars are treated as either petrol or diesel cars for this purpose.

Definition of a "person"

The respondent bank was a branch office in Grenada whose head office was in Canada. Between 2001 and 2006, the bank made seven payments to the head office. In February 2008, the comptroller of Inland Revenue assessed the bank to pay withholding tax on those payments under Income Tax Act (No 36 of 1994) Grenada, s 50(1). The Appeals Commissioners and the Chief Justice upheld the assessments, but the Court of Appeal of the Eastern Caribbean Supreme Court allowed the bank's appeal, for reasons which included the following:

- the bank could not be regarded as a legal person engaged in business on its own account in Grenada;
- the definition of "person" in s 2 did not include the unincorporated head office of a foreign bank operating in Grenada;
- the payments in question were not subject to deduction of withholding tax;
- in any event, the payer and the payee being the same person, s 50 of the Act had no application; and

- the payments had not been made to a person within the meaning of that word in the Act.

The commissioners appealed to the board of the Privy Council. The issue before the Privy Council was whether the bank and the head office were both persons within s 50(1).

Decision:

The Privy Council agreed with the Court of Appeal that the natural meaning of the words in s 50(1) was that there had to be a payment by one person to another. It was not a natural use of language to suggest that a transfer of funds by one person from one account to another account could be described as a payment by a person to a person. The use of the word "payment" was appropriate in such circumstances, but did not inevitably make that a payment by a person to a person.

The commissioners' appeal was dismissed.

Comments – Although this case clearly deals with the tax definition in a Commonwealth country the case was heard in the Privy Council and of course assists in interpreting British law where relevant.

The Appeal Commissioners v Bank of Nova Scotia, Privy Council,

Annual and lifetime allowance planning and pitfalls (Lecture P796 – 7.47 minutes)

Claiming unused annual allowance carry forward

HMRC are seemingly likely to check any claims.

The basic position is that if the annual allowance has not been fully utilised it can be carried forward for 3 years, on a FIFO basis and based on the annual allowance always having been £50,000. It is claimable only after the annual allowance for the tax year of payment of the UAA has been fully utilised.

Illustration

	Pension input amount	Actual limit	Deemed limit	UAA c/fwd
	£	£	£	£
2010/11	28,000	255,000	50,000	22,000
2011/12	30,000	50,000	50,000	20,000
2012/13	35,000	50,000	50,000	15,000

In 2013/14 the annual allowance is £50,000 + unused allowance for 2010/11, 2011/12 and 2012/13 of £57,000 = total of £107,000.

If the actual contribution in 2013/14 is £60,000, the unused allowance c/fwd at 5 April 2014 is £20,000 + £15,000 = £35,000, with the balance for 2010/11 of £12,000 (£22,000 - £10,000 used in 2013/14) being lost.

The UAA only arises for a particular tax year if in that tax year the individual is a member of a registered pension scheme, but it does not matter that no contributions may have been made in that tax year to that scheme. It also does not matter if that scheme is not the same as that in which he is to invest the UAA.

A claim to cover all or part of the UAA available is not separately identified in the tax return as all you need to state in Box 1 of page TR4 is the total payment made to registered pension schemes in the tax year. It now seems essential practice to identify the use of the UAA in the "any other information" section in Box 19 on page TR6, so as to hopefully avoid any unnecessary enquiry into the validity of the claim.

HMRC are prone to ask for a lot of information and some documents on an enquiry into pension contributions exceeding the basic £50,000 as follows:

- Page 24 (Working Sheet) of the Helpsheet 345 if one was completed when the tax return was prepared.
- Any calculations prepared showing the unused relief b/fwd to arrive at the entry in Box 1 of page TR4.
- A certificate of pension savings contributions, confirming the amount claimed.
- Employees only – does your client belong to an employer-funded pension scheme? If so (a) does he contribute into the scheme also?; (b) does his employer operate a relief at source scheme; and (c) what was the amount contributed by his employer?
- How many registered pension schemes is your client a participator in?
- What was the date of your client's entry into each of those schemes?
- What is the nature of each scheme (e.g. money purchase/defined benefits)?
- What pension input period was used for the claim made on the tax return for each scheme?
- If it was not possible to provide any calculation under 2. above, what UAA has been brought into this tax return, indicating the year and the amount brought forward?

Individual protection for the lifetime allowance charge

Given the fact that where a tax charge arises it is at a rate of 55% (where the excess is taken as a lump-sum), and the level of the allowance is reducing as announced, it is essential that you are aware of how the rules work so that the increasing number of individuals being caught can plan properly.

The LTA is the limit on the accumulated value of tax advantaged pension savings that an individual can benefit from. The LTA is £1.5m but reduces to £1.25m from 6 April 2014.

There is Fixed Protection 2014 (FP14) being legislated for, and a proposed Individual Protection 2014 (IP14) which is subject to consultation.

Where either protection is available it is subject to a limit of the current LTA of £1.5m or, if greater, the standard LTA applying when the benefit crystallisation event (BTE) arises.

The main aspects are:

An application for FP14 has to be made by 5 April 2014. It results in retaining the LTA as £1.5m but that is withdrawn if any further contributions are made after that date to a money purchase scheme, or savings in a defined benefit arrangement increase above a prescribed %.

Any new pension savings or excessive benefit accruals from 6 April 2014 therefore result in the individual being tested against the standard LTA of £1.25m (or such greater level as may apply when the BTE arises).

The IP14 proposal gives individuals a personalised LTA based on the value of their 2006 A-day BTEs, pre A-day pensions in payments, and relevant pension savings at 5 April 2014 up to £1.5m. The value at 5 April 2014 needs to be over £1.25m, with the personalised LTA applying until it is exceeded by the standard LTA.

Subject to the consultation exercise, there may be a 3 year time limit of 5 April 2017 to notify reliance on IP14, thereby giving a good deal of time to obtain the necessary valuations and make the application.

You can apply for both FP14 and IP14 if meeting the eligibility conditions; FP14 takes precedence.

It is also intended that IP14 will be available to those with fixed protection in 2012 (FP12 when the LTA reduced from £1.8m to £1.5m), but not for those with primary protection and enhanced protection in respect of the 2006 A-day changes.

Contributed by Gerry Hart

Benefit options from defined contribution schemes (Lecture P797 – 9.45 minutes)

The options are numerous and the tax aspects are of great significance in deciding the optimum action to take. Even more flexibility is likely to be available in due course, given the continuing picture of low annuity rates

Lump-sum benefits at 55

This can be up to a tax-free level of 25% of the fund value and can be taken from the age of 55. Any lump-sum taken from funds exceeding the lifetime allowance are taxed at a rate of 55%.

Secured pension benefits

This involves purchasing an annuity for life.

- It can be guaranteed, but if so not for longer than 10 years.
- It can also be paid with an increase each year and/or on a capital protection basis.
- It can cease on death (single life) or pass to a dependant (joint life) to the extent of 2/3rds.
- It can only be assigned to another person by HMRC agreement – typically under a pension sharing order on divorce.

Drawdown pensions

These are unsecured and can be flexible or capped.

A flexible drawdown can be of any % of the fund value and is liable to income tax with no top-slicing. It is only available if the individual is entitled to at least £20,000 of secured income for that tax year. That consists of:

- Pension payments or annuity payments from a registered pension scheme
- Similar payments under an overseas pension scheme
- State pensions

A capped drawdown means the individual is not locked-in to what is often an unacceptably low annuity rate. There is a maximum drawdown of 120% of the equivalent single-life annuity rate applying for the age concerned, where the income drawdown year begins after 25 March 2013. Previously it was 100%.

It relates to 120% of the GAD rates set by the government actuary department, which uses age and rates determined by current yields on 15 year gilts. It broadly corresponds to 120% of the single level annuity that could be purchased at the relevant age.

Phased drawdown can be arranged whereby the maximum amount is not taken.

The exact maximum capped drawdown is calculated by the scheme administrator at the start of the first pension year and then every three years until the individual reaches 75.

If an annuity is still not purchased then, the drawdown can continue but there is a recalculation at the start of each pension year.

The individual may request a new calculation before the end of any given pension year, but the scheme administrator is not obliged to agree to do that.

If aged at least 75 the individual can ask the administrator to change the end date of the pension year - e.g. to align them for different schemes - but that can only be done once for any scheme.

Lump sum benefits on death

Funds that have not yet been used to make payment of benefits are uncrystallised funds and can be paid tax-free to a dependant if the deceased was less than 75. If 75 or over there is a tax charge of 55%.

A pension protection payment can be made if the deceased was receiving a lifetime annuity or scheme pension and opted for a guarantee that a set amount of pension is provided. If he dies before that amount has been paid the balance can be paid as a lump-sum, but with a tax charge of 55%.

A payment out of a drawdown pension can be made if the deceased was receiving a drawdown pension that was not funded by a short-term annuity. The remaining funds can be taken as a lump-sum, with a tax charge of 55%.

Where payment of a lump sum benefit on death is made to the legal personal representative through the discretionary powers of the trustees, or to the scheme administrator where there are no trustees, the value of the benefit is not normally included in the deceased's estate for IHT purposes.

Where such a benefit is payable as of right to the legal personal representatives it does form part of the estate for IHT purposes. However, that can be avoided by using a declaration of trust.

Dependant's pensions

Subject to the rules of the scheme and of course the terms of any benefits taken before the death, a dependant can receive a secured pension of 2/3rds; an annuity of 2/3rds; or a drawdown pension.

The drawdown can be flexible or capped, using the same rules as for the deceased in his lifetime, but the lifetime allowance is not taken into account.

A dependant for pension and lump-sum benefits on the death of the member is any of the following:

- a spouse or civil partner of the scheme member when he died
- a spouse or civil partner of the scheme member when he first started to draw the pension (but only if the scheme rules allow)
- a child of the scheme member aged under 23 or, if older, was at the time of the death dependent on him because of physical or mental impairment
- some other person who in the opinion of the scheme administrator at the date of the member's death (a) was financially dependent on the member; or (b) their relationship was one of mutual dependence; or (c) was financially dependent on the scheme member because of physical or mental impairment

Contributed by Gerry Hart

Capital Taxes

Residential property as employee accommodation (Lecture P798 – 13.08 minutes)

The recent First-Tier Tribunal decision in *Shing Cheung Mak v HMRC (2013)* highlights an interesting argument about whether a residential property in Oxford, which was bought in September 1995 by the proprietor of a Chinese restaurant in order to house workers who were employed in his business, constituted a business asset for taper relief purposes on its sale at a substantial profit in October 2006.

HMRC's contention was that, in order for an asset to be used wholly or partly for the purposes of an unincorporated business (which was a key requirement of the taper relief legislation), it had to be used as an 'integral part' of the trade. In this case, the essence of the trade was the buying, cooking and selling of food. The provision of residential accommodation was not, HMRC argued, part of the core trading activities. They also pointed out that the property was not shown as an asset of the business in the restaurant accounts.

The taxpayer's accountant, in reply, submitted that there was no difference – in principle – between the Oxford property and a company car provided to an employee (or the acquisition of a staff car park or crèche). He accepted that it was questionable whether the purchase of such assets was an integral part of the restaurant's core trading activities, but he pointed out that there would never have been a suggestion that, for example, capital allowances could not be obtained on the cost of a car. Admittedly, there is a slightly different test which is applied for capital allowances purposes, but the main purpose of this argument was to make the point that HMRC were taking an 'unduly narrow view' of the CGT status of such assets.

There also appears to have been no suggestion that the house in Oxford represented job-related accommodation, in which case the exemption in S99 ITEPA 2003 would have applied. The proprietor received no rent from his staff and a PAYE Settlement Agreement had been entered into for the whole of the relevant period. The Tribunal felt that this latter point was 'very persuasive'.

Indeed, they went on to say that the CGT legislation was 'broadly worded' and so they saw no reason to restrict its meaning in the way in which HMRC were inviting them to. They concluded:

'We consider that, in the absence of some particular circumstance which casts doubt on the true underlying purpose, the provision of accommodation to employees working in a business is capable of being an integral part of its trading activity as a whole and, as such, the use of a residential property for that purpose is capable of being a use which is wholly or partly for the purposes of the relevant trade.'

Business asset taper relief was therefore available for the relevant period for which the property was so used.

Although the wording in S169L TCGA 1992 is somewhat different, there seems little doubt that the principle should also hold good in the context of entrepreneurs' relief.

Contributed by Robert Jamieson

Not a main residence

Mr Llewellyn and his partner lived at 10 Netley Terrace, Southsea — a property purchased as tenants in common in 1976. By 1996, they had personal difficulties and he purchased 10 Henderson Road, Southsea in 1996, moving into the property with a sleeping bag and basic necessities. The house was in a poor state and it took a year to refurbish it. During that time he returned to Netley Terrace to collect mail and carry out work on that property.

By the summer of 1998, his relationship with his partner had improved and Mr Llewellyn moved back to Netley Terrace, subsequently renting out Henderson Road. Letting continued until 2005 when, following further work to it, the property was put it up for sale, being sold in May 2007.

HMRC requested information to support the claim that only or main residence relief and lettings relief applied to Henderson Road, because their information was that he had lived permanently at Netley Terrace. Following various correspondence with the accountant, HMRC issued an amended self-assessment refusing relief and, following reviews, the appeal against this came to the First-tier Tribunal.

Decision:
There was some dispute as to when Henderson Road was first occupied, but the tribunal accepted that Mr Llewellyn moved there in November 1996, although living in very spartan conditions. It was noted, however, that he was still registered to vote at Netley Terrace and no other institutions appear to have been advised of an address change. In response to questions from HMRC, he also admitted that he gave Netley Terrace as his address when applying for a credit card. Rent records indicated that the property was let from October 1997.

The tribunal accepted that the taxpayer had occupied the property, but some degree of permanence or continuity was required. The tribunal did not consider, on the balance of probabilities, that this had been satisfied and refused the relief.

The tribunal concluded with “a procedural matter”. Despite both parties confirming that no witnesses were being called, HMRC had asked to put questions to Mr Llewellyn. He could have refused to answer, in which case it would have been left to the tribunal to determine whether HMRC's application to question Mr Llewellyn should or should not be granted. Had this not been granted, there would have been no opportunity for HMRC to question him. The tribunal did not think it fair for HMRC to wait until the hearing to “spring upon” an individual a request to give evidence where that individual has been led to expect that this would not be required. The tribunal decided not to comment on whether his accountant should have decided not to call Mr Llewellyn as a witness in support of his own case.

Comments – The principal private residence relief is a very important and valuable relief. There have been many cases demonstrating the importance of being able to prove the permanence of the occupation of the property of which the Goodwin v Curtis case is one of the most often referred to. The permanence must be demonstrated and the quantity and the quality of the evidence can often be a determining factor. The almost complete lack of evidence therefore worked against the taxpayer.

Wade Llewellyn v HMRC TC2726

Whether house used as principal private residence

A financial adviser (M) purchased a two-bedroomed house (110H) in 2002. He let it to tenants until November 2006, when he moved into it after separating from his wife. However, he arranged for correspondence to be sent to the house of his new partner (J), with whom he purchased another house in July 2007 (and whom he subsequently married after divorcing his first wife). In August 2007, M sold 110H. HMRC issued an amendment to his self-assessment, charging CGT on the gain. M appealed, contending that he had occupied 110H as his principal private residence.

Decision:

The First-tier Tribunal rejected this contention and dismissed his appeal. Judge Walters found that M's occupation of the house 'did not have any degree of permanence or expectation of continuity' and that he had 'an expectation of being able to move from (110H) and set up home by buying a house jointly with (J)'. M had never envisaged 110H as a long-term home, so that his occupation of it did not constitute 'residence' for the purposes of TCGA 1992 ss 222, 223.

Comments - As observed by David Whiscombe (director at BKL Tax), this case 'concerned PPR relief on a property which had been occupied as a home for a period of seven months before sale. Somewhat surprisingly, relief was denied, essentially on the grounds that such a period was too short to give the degree of permanence required to constitute the property a residence. If that decision is correct (which is doubtful), many gains previously considered exempt may be at risk of challenge and it may be appropriate to consider “protective” disclosures under [HMRC's recent] property sales campaign.'

P Moore v HMRC TC2827

Let for investment

The taxpayer bought a property (180 Grange Road) in September 2001 and sold it in December 2005. HMRC assessed him to capital gains tax on the gain on the basis that it had been held as an investment. The taxpayer appealed. He said no chargeable gain arose because it was a disposal of trading stock.

The taxpayer said his aim was to buy, develop and sell property. However, the business was hit by cashflow difficulties, so he let 180 Grange Road to finance his other trading activities. Although this was intended to be a temporary arrangement, the house was let for several years until it was sold.

Decision:

The First-tier Tribunal said there was no reliable evidence that 180 Grange Road had been purchased as trading stock. It was let very soon after it was acquired and continued to be let until its disposal. The judge did not accept that the property was let as a temporary measure because it was let before the financial problems arose. He concluded the property had been bought as an investment.

The taxpayer's appeal was dismissed.

Comments - The FTT upheld HMRC's contention that the appellant's profit on the sale of the house was chargeable to capital gains tax rather than income tax.

A Headley v HMRC TC2779

Valuation at 31 March 1982

An individual (B) purchased a three-storey house in Harrow in 1970. He converted it into offices and used it as such for many years, although it was subsequently reconverted into flats. He sold the house for £482k in 2006. In his 2006/07 self-assessment, he computed the gain on the basis that, at 31 March 1982, the value of the property had been £200k. HMRC issued an amendment reducing the value to £100k. B appealed.

Decision:

The Upper Tribunal reviewed the evidence in detail and allowed the appeal in part, holding that at 31 March 1982, the rental value of the property had been £11k pa and that this should be multiplied by 12.5, giving a value at that date of £137.5k.

Comments - The Upper Tribunal held that the value of the property at 31 March 1982 should be ascertained by assessing the rental value and multiplying this by 12.5, thus arriving at a figure which was lower than the appellant's valuation but higher than HMRC's valuation. The importance of the methodology of valuation and the multiples produced shows how the valuation can vary substantially. In this case the taxpayer was partly successful with the Tribunal determining a value between the original taxpayer's valuation and the HMRC valuation

MB Blum v HMRC (Upper Tribunal)

Administration

Penalties on undeclared restaurant takings

The decision in Khawaja v HMRC (Upper Tribunal) is the latest instalment in a long-running saga.

The Revenue had issued assessments on the controlling director of a company which operated an Indian restaurant, on the basis that he had received undeclared income which represented undisclosed remuneration from the company. The assessments included rent, which the company had paid on behalf of the director, benefits in kind, and amounts in respect of takings which the Revenue considered had been abstracted by the director without appearing in the company's records. The director (K) appealed, accepting that he was liable to tax on the rental income and the benefits in kind, but contending that there had been no undeclared takings. The general commissioners upheld the assessments in principle but reduced them in amount, finding that there had been undeclared takings but that the amount assessed was excessive. The commissioners determined the amount of undeclared takings by applying a mark-up to the amount of meat which the company had purchased, and determined the amount of undeclared remuneration in amounts varying from £15,000 for 1992/93 to £71,000 for 1998/99.

K appealed to the Ch D, which upheld the assessments in principle but reduced the amount of each assessment by £5,000 ([2004] STC 669). Following this decision, the Revenue imposed penalties totalling £41,332 on K under TMA 1970 s 95. K appealed to the general commissioners, who upheld the penalties in principle but reduced them to £6,000, holding that they should apply the criminal standard of 'proof beyond reasonable doubt', and finding that although the Revenue had shown that K had negligently understated income from property and benefits in kind, the Revenue had not proved that he 'negligently understated income in respect of remuneration'. The Revenue appealed to the Ch D, contending that the commissioners had misdirected themselves as to the standard of proof, and should have applied the normal civil standard of the balance of probabilities.

The Ch D accepted this contention and remitted the case to the commissioners for rehearing ([2008] STC 2880). Mann J observed that in 1983, the Keith Report of the committee on the enforcement powers of Revenue departments had 'assumed that a civil penalty system for dishonesty in relation to income tax required proof only to the civil standard', and that this reasoning had been applied in subsequent VAT cases in which 'it was plainly assumed that the civil standard of proof applied to the income tax regime'. It was 'sensible that the same standard of proof should apply' to income tax and VAT, and 'for the reasons given in the Keith report and referred to in the cases, that standard should be the civil standard'. The CA rejected an application by the director to appeal against this decision ([2009] EWCA Civ 399) and the FTT reheard K's appeals against the penalties relating to suppressed takings. Lady Mitting reviewed the evidence in detail and upheld the penalties in principle, directing that they should be imposed at the rate of 40% the evaded tax. K appealed to the Upper Tribunal.

Decision:

The Upper Tribunal allowed his appeal in part, directing that the penalties should have been imposed at 35% of the tax and that there should be a further reduction of 10% to reflect the fact that K's appeal had not been heard 'within a reasonable time'.

Comments - The CA rejected an application for leave to appeal against the High Court decision, suggesting that it agreed that the standard of proof with regard to penalties is the civil standard rather than the criminal standard. With regard to the quantum of the penalties on the suppressed takings, the Upper Tribunal reviewed the evidence in detail and directed that they should be imposed at the rate of 35% of the evaded tax on the underdeclared takings, and that there should be a further reduction of 10% to take account of the delay in hearing the director's appeal. The result is that, after fighting a long rearguard action, the director has to pay penalties totalling £18,347, rather than the £6,000 imposed by the general commissioners.

Khawaja v HMRC (Upper Tribunal)

Role for Cotter Principle

The taxpayer was a VAT registered self-employed hirer and supplier of plant and machinery. He also received a salary in respect of his directorship of a company. He submitted his 2007/08 and 2008/09 tax returns, in which he disclosed substantial taxable income from employment, self-employment and investments, and also some chargeable gains. The tax and National Insurance due for each year was £1,049,061 and £998,892 respectively.

In 2008/09, he took part in transactions which resulted in a loss of £1.5m. The taxpayer applied to carry back the loss and have it offset against the tax due for 2007/08 under ITA 2007, s 132. Because the losses had taken place before he submitted the 2007/08 return, the taxpayer indicated in that return that he was claiming relief of £600,000 in that way.

HMRC said the losses were made as a result of the use of tax avoidance schemes and opened enquiries under TMA 1970, s 9A into both tax returns. They ruled that the losses were not available to be set off under ITA 2007, s 132.

In 2011, the taxpayer submitted a VAT return which showed a repayment due of £698,330. HMRC sought to offset the repayment against the tax due for the earlier years.

The taxpayer sought a judicial review of HMRC's decision.

Decision:

The Upper Tribunal followed the Court of Appeal's decision in CRC v Cotter [2012] STC 745, that once HMRC had begun an enquiry into a tax return under TMA 1970, s 9A, they could not also instigate an enquiry under Sch 1A para 5. In this instance, the tribunal concluded that the taxpayer had claimed to carry back loss relief from 2008/09 to his 2007/08 return, and therefore HMRC did not have the power

to bring an enquiry under Sch 1 para 5, but were required to open an enquiry into his return under s 9A: "There was, therefore, no valid exercise of the power, and correspondingly no debit on Mr Rouse's account against which the VAT credit due to him might be set off." The judge considered this "to be a surprising result", but concluded that Cotter was in point.

The taxpayer's application for judicial review was granted.

Comments - HMRC has appealed to the Supreme Court against the CA decision in Cotter. If its appeal is unsuccessful, there are likely to be further changes to the legislation to close the apparent loophole which has been revealed by Arden LJ's judgment in Cotter, in addition to the changes already included in FA 2009 s 68, which introduced ITA 2007 s 128(5A).

R (on the application of Rouse) v CRC, Upper Tribunal

Where's the evidence?

The executor of T appealed against a penalty imposed for the late submission of a trust tax return for the year ended 5 April 2012. The return was submitted on paper on 14 January 2013. HMRC imposed a penalty on the basis that paper returns for the year should have been submitted by 31 October 2012. The executor filed an electronic version of the return ten days later on 24 January. He explained that the reason for the paper form had been to submit with it a covering letter confirming that it would be the final return.

HMRC said their guidance stated that "if a paper return is filed late, it is not possible to avoid a penalty by filing a further tax return online before 31 January". The taxpayer appealed.

Decision:

The First-tier Tribunal said the issue was whether the paper document was a valid return. In essence, according to HMRC's practice, this meant the return had to be signed by the taxpayer. The department did not produce the paper return as evidence to the tribunal and, although the covering letter which referred to a return was provided, this was not sufficient to show that the return was a valid one for the purposes of TMA 1970, s 8A.

The taxpayer's appeal was allowed.

Comments – Submission of tax returns at the correct time is crucial to the working of the tax system. Accordingly there have to be very defined and tight procedures particularly when submission of a paper return is available to a particular date and the submission of an electronic return is required after that date. In this case HMRC did not prove their case with the appropriate evidence and consequently the taxpayer's appeal was allowed.

Executor of the estate of Teresa Rosenbaum (deceased) TC2804

Special circumstances

A property company was late in making payment of pay as you earn/National Insurance liabilities in for 2010/11 and HMRC imposed a penalty under FA 2009, Sch 56 of £9,701, subsequently reduced to £6,151. Schedule 56, para 16 provides that if there is a reasonable excuse for the failure to pay on time, then there will be no penalty, but para 16(2) states that:

- an insufficiency of funds is not a reasonable excuse, unless attributable to events outside an employer's control;
- the reliance on somebody else to do something is not a reasonable excuse, unless reasonable care was taken to avoid failure; and
- if there was a reasonable excuse for the failure, that excuse is deemed to have continued if the failure is remedied without unreasonable delay once the excuse ceased.

The penalty regime started on 6 April 2010 and the penalties are on a sliding scale — the more late payments in a tax year, the larger the percentage penalty applied to the aggregate. The first default in any year is disregarded altogether. The remaining defaults trigger a penalty of 1%, 2%, 3% or 4% depending on their number. The 4% penalty applies where there are 10 or more defaults. In this case, a 3% penalty applied where there are seven, eight or nine defaults.

The tribunal heard that the company had at one time been very successful, turning over £4.5m, but had suffered as a result of the 2007 property crash. Forty-five employees had been laid off, the bank had withdrawn the overdraft facility and two directors had put £800,000 into the company to support it. The main director, Mr Bevins, was severely dyslexic and had suffered a heart attack in September 2009.

Letters notifying late payment of PAYE had been sent to the company in 2009 and 2010. HMRC argued that the company's cashflow problems did not amount to a reasonable excuse for late payment — the property crash had happened too long ago. The department said it was the company's habit to pay late rather than there having been a particular event that had “led to a flip in an otherwise impeccable payment record.”

Decision:

Having considered the evidence, the tribunal held that it did not consider that there was a reasonable excuse for the late payment of the liabilities. Six months would generally be considered to be the length of time beyond which an event would no longer constitute grounds for a reasonable excuse.

However, the tribunal did believe that there were some special circumstances in this case.

Mr Bevins had had little formal education, he was dyslexic and had suffered a heart attack six months before the start of the tax year in question. He had tried to ease cash flow problems by moving to monthly VAT returns but had not been allowed to because the company was not up to date with payments. The tribunal did not criticise HMRC for failing to take these factors into account — some

had only come to light during the hearing — but it felt that these were special circumstances and, under FA 2009, Sch 56 para 13(2), it exercised its powers to determine that a penalty should not apply to months two and three, thus reducing the penalty charge further.

Comments – The importance of providing evidence to the Tribunal of all the facts and efforts to comply with the law was amply demonstrated in this case which resulted in a case which was fairly run of the mill finishing with a positive result for the taxpayer.

Claygold Property Ltd v HMRC TC2717

Revenue & Customs Brief 28/13

Avoidance cases – what happens to repayment claims?

Purpose of this brief

The purpose of this brief is to set out HM Revenue & Customs' (HMRC) policy on withholding repayment claims in avoidance cases. HMRC aims to stop tax avoiders from acquiring an advantage, even a temporary advantage, over the majority of taxpayers who don't try to get around the rules.

Who needs to read this?

Anyone involved in tax avoidance that leads to a tax repayment claim.

Background

In the year ended 31 March 2013, there were 32 decisions in the Tribunals and Courts in tax avoidance cases. HMRC won in 26 of those cases (82%) with over £1bn protected. This excellent result reflects the intensive investigations we conduct into the tax returns of people who use avoidance schemes. Our thorough approach means that it can take some years for our enquiries to be resolved, particularly if we have to litigate.

The small minority who engage in tax avoidance should not gain a tax advantage during the period from the tax due date to the time when we complete our enquiries and resolve any dispute. It is important that anyone who is considering using a tax avoidance scheme should be aware of the steps we will take to make sure that they will not benefit from it. Not only do we challenge the permanent tax result that the avoidance scheme claims to produce, but we also look to deny interim or temporary 'cash flow' benefits from engaging in avoidance, particularly where a scheme claims to give rise to a tax repayment or some other form of personal tax relief.

Withholding of repayment claims

In appropriate circumstances, we withhold income tax repayments where the claims which produce them constitute (in our opinion) tax avoidance, and where we are challenging or considering challenging those claims by enquiry. If we are satisfied that a claim for repayment does not depend (or does not wholly depend) on tax avoidance, we do of course work with customers and their agents with a view to

making an appropriate provisional repayment. Accordingly, if the repayment included (say) £100k in respect of a scheme and £50k in respect of other transactions, we would expect to repay the £50k quickly (unless of course there was some specific reason for us to doubt that it was correctly claimed). Similarly, if in our view the effect of a scheme is to inflate or accelerate a claim to relief artificially, we would work with customers and their agents with a view to making an appropriate provisional repayment to reflect the portion of the relief which was not in dispute.

Where possible in law, we also withhold giving effect to claims to other forms of personal tax relief which constitute (in our opinion) tax avoidance, and where we are challenging or considering challenging those claims by enquiry. We are not referring to National Insurance Contributions, where claims for repayment do not normally arise as a result of avoidance schemes. We are referring rather to examples such as claims made outside of tax returns, where we may enforce payment of a tax debt where the claim would otherwise have been given effect by discharge or set-off. Pending the Supreme Court's determination of HMRC's appeal against the Court of Appeal's decision in the Cotter case (Maurice David Cotter [2012] EWCA Civ 81), we will not enforce debts which are on all fours with it without recourse to the Tax Tribunal. If we are satisfied that a claim for discharge or set-off does not depend (or does not wholly depend) on tax avoidance, we will work with customers and their agents with a view to giving appropriate provisional effect to the claim.

Where we withhold repayment claims or withhold giving effect to claims to other forms of personal tax relief, the tax avoidance scheme in question will be subject to HMRC's anti-avoidance governance process under which the Anti-Avoidance Board (made up of senior officials from across HMRC) approves strategies for challenging avoidance schemes. This ensures consistency in handling similar (or apparently similar) avoidance risks.

If we withhold a repayment in any income tax case, our guidance makes it clear that there should be no undue delay in opening an enquiry. In some instances (for example mass marketed tax avoidance schemes) we may need to make use of the full enquiry window to ensure all enquiries and linked enquiries are opened into returns and claims made by users of the scheme. However, if the scheme user so wishes and they (or their agent) contact us before we open an enquiry into their relevant return or claim, we will confirm whether we have withheld a repayment or other personal tax relief because we believe it relates to a tax avoidance scheme which we are challenging or considering challenging.

Single compliance process launched nationwide **(Lecture P799 – 9.57 minutes)**

The process

As yet another attempt to change the enquiry regime in terms of working an enquiry, HMRC announced trials of a single compliance process (SCP) for enquiries across a range of different taxes, aimed at local compliance enquiries on SMEs. This is clearly resource driven, and a further briefing paper for tax agents was published to announce changes to the original plan as well as reiterating points made previously.

By simplifying and standardising the process for compliance checks HMRC will they claim improve customer experience and reduce costs as the check will only take as long as the risks and behaviours encountered dictate.

The trials

HMRC wants to ensure that the SCP is fit for purpose and accomplishes the aims that they have set out to achieve. In order to do this, HMRC extended the original trial phase for further testing in some of the more technically complex areas, to better understand how they will benefit from an SCP approach. The extended trial ran until sufficient conclusive data was available to ensure a convincing business case for roll out, which is robust and fully supports proposed implementation plans.

Evaluation findings

The trial concluded on 31 March 2013 and the key findings have now been published:

- direct tax enquiries were concluded more quickly
- the new process did not slow down the current process of conducting VAT visits
- there is scope for further improvements by working some cases via telephone and/or written correspondence
- 86% of customers responding to the customer satisfaction questionnaire were extremely positive about their experience
- agents were complimentary about the new process with 63% of respondents reporting a more positive experience under SCP

The key elements which contributed to improved process times and increased customer satisfaction will now be applied in small and medium enterprise cases.

The way ahead

With SCP having been adopted for SME enquiries, the framework being used is designed to concentrate solely on the risks or behaviours identified by reference to 3 different approaches detailed overleaf.

1. Desk based - for cases that can be worked either by correspondence or over the telephone, as HMRC currently does with Income Tax and Corporation Tax aspect cases and VAT pre-repayment credibility queries
2. Visits - to provide a simplified and faster route for those cases where a face to face visit is required (visits are distinguished between cases requiring either a 1 or 2 day visit)
3. Evasion - to address those cases showing evasion characteristics requiring evasion approaches from the outset such as surveillance or unannounced visits

Driving the enquiry (with HMRC behind the wheel)

The claim is that the SCP will allow for the enquiry to be driven by the risks or behaviours identified and that, according to HMRC, includes:

- Building on the principles of the openness and early dialogue by informing the taxpayer and agent at the first opportunity of the particular risks to be addressed to give time savings and clarity for both parties about the risks being addressed.
- Developing a relationship with the agent/business for mutual understanding of the benefits of particular approaches and how these maintain the pace or speed up the process at every stage in the enquiry.
- Collaboration beteen HMRC and agent/business at every stage in the enquiry and communicating any findings directly so that there should be "no surprises".
- Swifter record reviews carried out "on site".
- Only seeking the facts and evidence to address the particular risks identified and not using the enquiry to undertake a general "fishing expedition", meaning that discussions are more focussed.
- Sample record reviews as opposed to a full review when appropriate.
- Working to Litigation and Settlement Strategy principles, importantly that HMRC will not generally enter into a dispute unless the revenue flows potentially involved justify doing so.

Levels of enquiry

There are 4 levels of enquiry under SCP

LEVEL 1: This is where there is no need for a face to face meeting. Maximum time estimated to work the enquiry is 1.5 days.

LEVEL 2: A simplified and faster route for those cases where a lower intensity face to face intervention is required. 2 days estimated.

LEVEL 3: Cases requiring a greater amount of time because the depth and breadth of the enquiry is more involved. 4 days estimated.

LEVEL 4: The most demanding cases such as those indicating tax evasion characteristics or those highly complex in nature. 8 days estimated.

Stages of the SCP

There are five stage:

STAGE 1 - PLANNING

STAGE 2 - CONTACT

STAGE 3 - PROCESS

STAGE 4 - RESOLVE

STAGE 5 - CLOSE

Your role

Your role to ensure all is fair for your client

Clearly this is a resource driven initiative, being sold to us on the basis that it will reduce the time, costs and hassle experienced by agents and clients. You must ensure that in adopting the SCP approach none of the following happens:

HMRC unfairly seeks to obtain agreement to additional taxable profits arising, by encouraging your client to settle if he wants them to make a speedy exit. Do not allow HMRC to rush things along if you consider that will be detrimental to the client.

HMRC use SCP but wrongly identify what they consider to be risk areas – perhaps as a result of only a superficial consideration of what they regard as facts but which in reality are nothing of the sort. That may well be derived from a check-list review which you feel shows a basic lack of understanding of how the business operates. If so, you need to be ready to make the point firmly and at an early stage of the enquiry.

HMRC attempts to apply a higher level to the enquiry than you consider justified.

HMRC use the 4 levels approach to insist on a meeting with the client when you consider that all can be settled without that.

A tax enquiry becomes drawn-out and HMRC seemingly refuses to apply this initiative even though it has been adopted nationwide. You could refer to the SCP procedures to try and get the enquiry settled.

Contributed by Gerry Hart

Incorrect Information and Advice by HMRC (Lecture P800 – 14.46 minutes)

Everyone makes mistakes. HM Revenue & Customs (HMRC) is no exception. Incorrect information and advice is sometimes given by HMRC to taxpayers. For example, incorrect information and advice may take the form of:

- Specific advice given to a taxpayer (e.g. by writing, or over the telephone); or
- Published information (e.g. in HMRC's procedural manuals, booklets, helpsheets or on HMRC's website)

Is the taxpayer bound by HMRC's incorrect information and advice?

HMRC's position is that it is generally not bound by any information or advice it gives which is incorrect in law. However, in certain circumstances, HMRC will consider itself to be bound by such incorrect information and advice. Alternatively, the courts may consider that the taxpayer had a 'legitimate expectation' to rely upon it.

Legitimate expectation

'Legitimate expectation' is a doctrine of public law. It applies the principles of fairness and reasonableness to circumstances where a person has an expectation or interest in a public body retaining a long-standing practice, or keeping a promise.

Taxpayers have had mixed fortunes before the courts in arguing that they had a legitimate expectation to rely upon HMRC guidance. For example, in Cameron v HMRC (and related application), QB [2012] EWHC 1174 (Admin), the High Court held that a HMRC publication referring to a 'broad concession' in the claimants' favour had given the claimants a legitimate expectation that their claims for the seafarer's earnings deduction would be allowed.

By contrast, in R (oao Davies & James) v HMRC [2011] UKSC 47, the Supreme Court held that Revenue Pamphlet IR20 ('Residents and non-residents – Liability to tax in the United Kingdom') did not give the taxpayers a legitimate expectation that they should be treated as non-resident. Lord Wilson observed that relevant parts of booklet IR20 were "very poorly drafted" such that they lacked the clarity required for the taxpayers to have a legitimate expectation of being able to rely upon it.

Furthermore, it would seem to be necessary that taxpayers must have relied upon HMRC's incorrect information at first hand. For example, it is not sufficient for the taxpayer to have been given the advice from his or her agent, and for the agent to have obtained the relevant information from HMRC (Hanover Company Services Ltd v CRC [2010] UKFTT 256 (TC)).

In Revenue & Customs v Abdul Noor [2013] UKUT 071 (TCC), the Upper Tribunal held that the First-tier Tribunal does not have jurisdiction to adjudicate on legitimate expectation. It would appear that taxpayers wishing to argue for legitimate may need to make an application to the High Court under judicial review (as to the basic requirements for legitimate expectation, see 'Hoops a many' by Ximena Montes Manzano and Keith M Gordon, Taxation 22 August 2013). An application for judicial review is a complicated legal process, which is likely to be expensive.

HMRC discretion

HMRC has some limited discretion with regard to the collection and management of taxes. The power to exercise its discretion is contained in the Commissioners for Revenue and Customs Act 2005. Section 5(1) of that Act provides that HMRC are responsible for the "collection and management" of taxes.

In HMRC's view, this discretion allows it to be bound by incorrect advice in certain circumstances. HMRC's general policy on when incorrect information and advice from HMRC can be relied upon is included on its website: www.hmrc.gov.uk/pdfs/info-hmrc.htm.

Further guidance is provided in HMRC's Admin Law manual, in the context of incorrect case-specific advice. It lists a number of tests, all of which must be satisfied (ADML1300):

- The customer made it plain he or she was seeking fully considered advice and indicated what it would be used for;
- The customer provided all information relevant to the query;
- The advice given by HMRC was clear, unambiguous and without qualification;
- The customer acted in reliance on the advice (i.e. he or she did or refrained from doing something as a direct consequence of the advice);
- The customer would suffer detriment if the correct statutory position were applied; (e.g. he would be financially worse off than if the correct advice had been given in the first place);
- To apply the correct statutory position would be so unfair as to constitute an abuse of power.

These tests set the bar at a high level. For example, the taxpayer must suffer "real harm or loss" to satisfy the penultimate test above. This presumably means financial loss - "disappointment or upset" is not sufficient.

HMRC considers that if the incorrect advice seriously affects the customer's livelihood or business (such that the courts would regard a correct application of the law to be so unfair as to amount to an abuse of HMRC's power), HMRC would be bound by its previous incorrect advice if the other tests were also met.

If legitimate expectation does apply in the above circumstances, it only applies to the past. The taxpayer cannot rely on the same (incorrect) tax treatment indefinitely. HMRC will notify the taxpayer in writing that the correct tax treatment should be applied in the future, normally from the date on which the error was drawn to the taxpayer's attention (ADML2000).

If legitimate expectation does not apply (e.g. if the taxpayer has been misled by incorrect advice from HMRC, but the tests in ADML1300 are not satisfied), HMRC may be prepared to consider other forms of redress, such as paying any reasonable costs incurred by the taxpayer (see for example, HMRC's 'Complaints and Remedy manual' and 'Make a complaint to HM Revenue & Customs' on HMRC's website (http://www.hmrc.gov.uk/complaints-appeals/how-to-complain/make-complaint.htm)).

Contributed by Mark McLaughlin

Business Taxation

Allowances on property - disposals and symmetry (Lecture B797 – 16.37 minutes)

Depreciation is not tax-deductible. Instead tax relief is given via the capital allowances system. That is why capital allowances are sometimes referred to as 'tax depreciation'.

Capital allowances give tax relief for assets approved by Government, at rates controlled by it. In the context of most commercial premises those assets are 'machinery' and 'plant'. Machinery takes its ordinary meaning. Plant is business apparatus, which includes many standard fixtures in buildings. Fixtures are assets that are fixed to land or a building so that in property law they become part of that land.

In essence, capital allowances give tax compensation, or relief, to a business to reflect the wear and tear, or loss in value, of its income generating capital assets. Therefore, a fundamental statutory mechanism exists which makes sure that relief is only given permanently to a business that has actually suffered such an economic loss. When a property is sold which contains fixtures upon which capital allowances have been claimed, this requires the business to account for a 'disposal receipt' or 'disposal value' for tax purposes.

Capital allowances pooling

When expenditure is incurred on an asset that qualifies for capital allowances, the qualifying expenditure is 'pooled'. This means that it is notified to HMRC by being recorded, with other similar assets, in an appropriate ledger (called a ‘pool’) in the tax computation and return. This is the first step in claiming capital allowances. The second step is then to write-off some of that expenditure to claim the tax relief, for example, by means of an annual investment allowance, or a writing-down allowance at the appropriate rate.

Disposal receipts

When assets that have qualified for capital allowances are disposed of, a negative adjustment must be made to the pool that the qualifying expenditure was recorded in. An amount must be deducted or subtracted from that pool to reflect the value of that plant and machinery at the time of disposal. This is a disposal receipt, or disposal value.

This mechanism ensures that a taxpayer only benefits permanently from tax relief to the extent that they have actually suffered an economic loss, if any, on an item of plant or machinery.

Example one

A business buys some land and builds a building on it. The plant and machinery fixtures cost £100,000. It claims capital allowances by adding the qualifying expenditure to the appropriate pool, or pools, and writing-off the cost for tax purposes at the rate for each pool. After some years the assets become obsolete. So they are stripped out or the whole building is demolished. At that time the plant is worth nothing. So a disposal value of nil is subtracted from the capital allowances pools. By deducting nil the pool total is unaffected. There is no claw-back. The business keeps the expenditure already written-off for tax and the remaining balance yet to be written-off in future periods. Eventually when all of the qualifying expenditure has been written-off, the tax depreciation matches the actual economic loss suffered.

The qualifying expenditure can only be written-off for tax *once* across the assets' lives. But this can be complicated because properties change hands. In practice it can be possible for all of the qualifying expenditure to be wholly written-off by the first owner, or entirely by a subsequent owner, or in smaller tranches by several different owners over the building's life.

Disposal events

For plant and machinery generally disposal events are defined by Capital Allowances Act 2001 (CAA 2001) s 61. The two most common disposal events are:

1. The taxpayer ceases to own the plant or machinery (for example, they sell it or give it away), or
2. The plant or machinery ceases to exist as such (for example, as a result of destruction, dismantling, or otherwise).

For plant and machinery fixtures, disposal events are defined by CAA 2001 s 196. For fixtures this supersedes s 61.

Disposal values

Disposal values are also defined by s 61 and s 196.

If the plant or machinery is demolished or destroyed, the disposal value is the money received for its remains. This is normally nil, or more rarely scrap value.

If the plant or machinery is sold then it is the sale price. Or in the context of buildings it is a 'just and reasonable apportionment' (CAA 2001 s 562) of the sale price for the whole property.

There is also the option to override this by agreeing an election under CAA 2001 s 198 or s 199. This will be explained in a future seminar.

A seller's disposal value is capped at the expenditure pooled by the seller (CAA 2001 s 62). That is, the disposal value cannot exceed the qualifying expenditure added to the pool in the first place.

Accounting for disposal proceeds for tax purposes is mandatory. Not doing so is tantamount to failing to disclose taxable income.

Practicalities

If property is held for a few years in a longer-term (generally) rising property market, an apportionment (that is, proportion of the total property value attributable to plant and machinery) is normally greater than the expenditure originally incurred. This means that the seller has the capital allowances clawed-back on sale - because it has not suffered an economic loss. So claiming capital allowances can sometimes be a temporary, or timing benefit. It can become permanent if the qualifying assets are stripped out, or an appropriate election is entered into upon sale.

If the value of the property (and therefore fixtures apportionment) has fallen, the seller *would* retain some tax relief to the extent that it had actually suffered an economic loss.

A further rule, in CAA 2001 s 185, operates alongside this to limit a buyer's capital allowances claim for fixtures. Where the seller, or any prior owner, has claimed plant and machinery allowances upon fixtures from 24th July 1996, s 185 limits the buyer's claim to the seller's disposal value. Therefore, the treatment between seller and buyer is symmetrical. For plant and machinery fixtures *upon which capital allowances have previously been claimed* this prevents the buyer from ramping-up or inflating the value of those assets. Any fixtures upon which capital allowances have *not* been claimed are unaffected.

Example two

A business claims capital allowances on plant and machinery fixtures of £100,000. Years later it sells the property containing the fixtures. At that time a just and reasonable apportionment of the purchase price is say, £200,000. The seller must account for disposal proceeds in its tax computation and return. This is calculated as a just and reasonable apportionment of the sale price (that is, £200,000) capped at the amount originally claimed (that is, £100,000). Therefore, the seller's disposal is £100,000. It suffers a full claw-back. The buyer's claim is capped at the seller's disposal value (that is, £100,000).

If the seller had *not* claimed capital allowances for the fixtures it would not have been required to account for a disposal value (CAA 2001 s 64). The buyer's claim would be based on a just and reasonable apportionment of the sale and purchase price (, £200,000 in example two above). The restriction of s 185 would not apply because there is no requirement for the seller to account for disposal proceeds.

Finance Act 2012 changes

This changes from April 2014 when new rules brought in by Finance Act 2012 take effect. These introduced new CAA 2001 ss 187A and 187B, which will be the subject of a future seminar.

Contributed by Steven Bone

Extent of contamination

The taxpayer built a marina in Dorset and incurred capital expenditure of £8m in respect of sea defences, specifically:

- the construction of a stone sea wall built entirely on the seabed;
- an additional sea wall built partly on the foreshore and partly on the dry land area of the marina;
- a 1.2 metre high plinth to provide protection from flooding risk; and
- a surface water drainage network.

The company claimed relief under FA 2001, Sch 22, "remediation of contaminated land", on the basis that the seawater on the foreshore could harm the land part of the marina by way of wave, tidal surge or flood damage. HMRC refused the claim, saying the land was not in a contaminated state for the purposes of the relief. The taxpayer appealed.

Decision:

The First-tier Tribunal said Sch 22 was widely drawn, defining land that was in a contaminated state as in a condition that was causing harm or might cause harm. Land was defined as "any estate interest in or rights over land". This included the foreshore, even if it was at times covered with seawater, but not the seabed.

Looking at the work carried out, the dropped sea wall did not qualify for relief as this was built on the seabed. The additional sea wall would qualify because it was built on land and the foreshore. There was seawater on the foreshore and this could cause damage to property.

With regard to the plinth and drainage works, these were carried out on dry land on the site of the marina. The foreshore posed a risk to the land on which they were constructed, but that land was not contaminated. Therefore, relief was not due in respect of either of them.

The taxpayer's appeal was allowed in part.

Comments – This is interesting being the first case on land remediation relief. It is an area with its own legislation and definitions necessary to the application of that legislation. It is worth reading for interest but of course this area is unlikely to be the field for many practitioners.

Dean & Reddyhoff Ltd v HMRC TC276)

Duality of purpose – new case law (Lecture B796 – 7.35 minutes)

Introduction

Tax law has long said that where there is both a business and a private purpose in meeting an expense the "wholly and exclusively" test has not been met and the result is no tax relief at all unless any of the following apply:

- the expenditure can properly be split between business and private with the former qualifying for tax relief (the main example of this is motor expenses); or
- the private element was merely incidental to the business purpose; or
- specific tax law allows the expenditure; or
- HMRC practice allows a % of the expenditure

Two recent cases now make it clear (subject to any possible appeal) that changes in communications and in how people run their businesses nowadays since the basic rule was first introduced has no bearing on the matter and the courts are unwilling to apply the duality of purpose test in a more up to date manner. Any such change would need to be made via parliament.

HMRC v TIM HEALY UKUT0337

The Upper Tribunal has overruled the decision of the First-Tier Tribunal to allow the actor Tim Healy income tax relief on all his travel, subsistence and accommodation expenses which he incurred when working away from his home on a nine-month assignment. The Upper Tribunal decided that the FTT had failed to apply the 'wholly and exclusively' test properly, and sent the case back for reconsideration.

Main points made by the Upper Tribunal were:

We accept Mr Conolly's submission that the FTT failed to apply the "wholly and exclusively" test properly and in doing so made an error of law.

The correct approach to the "wholly and exclusively" test, as demonstrated by the authorities, is to consider it by reference to the dual purpose test. In this case this required the FTT to ascertain whether there was a dual purpose on Mr Healy's part in entering into the tenancy agreement for the flat in London for the duration of the Billy Elliot production. In that context, the FTT needed to consider whether in all the circumstances of the case, the sole purpose for renting the flat was in order to carry on his profession of an actor. In order to determine that issue it needed to consider whether the effect of his taking the flat, namely of providing him with the warmth, shelter and comfort that we all need was merely incidental to that purpose or was a shared purpose. If the former were the case the expenditure would have been deductible, if the latter there was a dual purpose and the expenditure would not be deductible.

It is clear that the FTT did not approach the test on this basis. Its finding, as set out in paragraph 36 of the Decision, focused purely on the issue as to whether in taking on the tenancy he was seeking a home in London. It appears to us that the test applied by the FTT was to ascertain whether Mr Healy had moved his home to London and proceeded on the basis that if he had not, then the expenditure could be regarded as having been made wholly and exclusively for a business purpose.

This approach would explain why, in its decision refusing permission to appeal, the FTT commented that if a duality of purpose test was applied expenditure for hotel accommodation could never be deductible as it inevitably provided shelter and warmth. However, the duality of purpose test is the test to be applied to see if the expenditure can be deductible, and the cases show that duality of purpose will not be found where the sole purpose is a business purpose and the accommodation costs which result in the provision of warmth and shelter are purely incidental to that. Applied in that way, that is considering whether the warmth and shelter is merely an incidental aspect rather than a purpose in itself, this creates no difficulty in finding that accommodation expenses can have a business purpose.

It is therefore clear that the FTT deliberately did not consider the question as to whether the shelter and warmth that inevitably follows from arranging accommodation was anything more than incidental to the business purpose that Mr Healy had in mind.

PHILIP MCMAHON V HMRC TC02799

Mr McMahon worked for a large recruitment consultancy which he left to set up on his own. When he left he took details of his employer's clients. This was in breach of his contract of employment and his former employer took action against him as a result of which he agreed to pay his former employer £100,000. He also incurred legal costs of over £15,000.

Mr McMahon argued that he incurred the expenditure in order to preserve his business, and on this basis it should be deductible against his profits. However, HMRC contended that the sum paid was at least partly referable to his breach of contract. As such there was duality of purpose and the expense was not incurred wholly and exclusively for the purposes of his trade so no tax relief at all.

The FTT decided that the expense was incurred for two purposes, first to preserve his business, and secondly to defend and settle the proceedings including the claim for damages for breach of contract and breach of fiduciary duty.

This means that there is duality of purpose and the expense is not deductible against profits. One imagines that the legal costs could be apportioned to create a modest claim, but then of course it might be regarded as capital expenditure?

Contributed by Gerry Hart

Optician changing from franchisee to locum: claim to loss relief

An optician (HA) worked as a franchisee until 3 April 2009. He made a loss in his final period of trading, part of which was carried back to his profit for the previous year. He subsequently began working as a freelance locum optician, and claimed that the balance of his loss for 2008/09 should be set against his income from this source in 2010. HMRC rejected the claim on the basis that HA's trade as a freelance locum optician was a different trade from his previous trade as a franchisee dispensing optician. HA's accountant accepted HMRC's rejection of the claim. HMRC issued a statutory demand for the tax due from 2010. HA then applied to lodge a late appeal against the rejection of his claim for loss relief.

Decision:

The FTT granted his application. Judge Radford found that HA 'had continued in his trade as a self-employed dispensing optician throughout'. He had been misinformed by HMRC and by his previous accountant, and 'had a reasonable excuse for making the late appeal'.

Comments - Although this was simply the hearing of an application to make a late appeal, the FTT's decision is worth noting with regard to the substantive issue of whether the appellant had continued his trade as an optician, or whether his trade as a freelance locum optician was different from his previous trade as a franchisee optician.

The FTT accepted the appellant's contention that he had continued a single trade as an optician, regardless of whether he had worked as a franchisee or a locum, so that he was entitled to the loss relief that he had claimed. (The decision consistently refers to the appellant as carrying on a trade as an optician, rather than a profession.

There have been conflicting decisions on whether an optician carries on a trade or a profession: compare Webster v CIR [1942] 2 All ER 517 with Carr v CIR [1944] 2 All ER 163.)

HL Amah v HMRC TC2805

Sponsorship of rugby club

Section 74(1) of the Income and Corporation Taxes Act 1988 provides, so far as material: “General rules as to deductions not allowable. Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of — (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation; ...”.

The taxpayer company was a fishing, fish processing, fish wholesaling (in the United Kingdom and internationally) and fish retailing business based in Plymouth. It was both a major employer in Plymouth and a significant business in the south west of England. Its retail business (within the stores of one of the major supermarkets retailers) traded as “South West Seafoods”. The taxpayer was wholly owned by JC and a family trust, and was controlled by C. It was common ground that C's state of mind amounted to the state of mind of the taxpayer. Plymouth Albion was a rugby club based in Plymouth (the club) and was a member of the Rugby Football Union (RFU). In the relevant years the club was one of the largest clubs in the south west. It played in the RFU's National Division 1 and was eligible for, and played in, the RFU's national cup competition drawing considerable crowds to home matches. In the relevant years, the taxpayer made payments to the club which it treated as deductible amounts in its accounts under the heading Advertising and Marketing. The sums paid represented about 1%-3% of the taxpayer's turnover. In about 1999, C became heavily involved in the club. At that stage, the club was in severe financial difficulties. C was asked to buy 300 shares and did so in order to help the chairman out and keep the club going. At that stage other sponsors would not increase their contributions. The taxpayer was prepared to be more generous. C wanted to be established in the business community in Plymouth and to have the value of the business connections that the club afforded. It was common ground that C

did obtain significant influence in the community through being the club's major sponsor in a way which could not be achieved by simply participating as a director. In 2003, C acquired more shares, but by or about 2006, he had achieved what he had wanted for the taxpayer and had told the club the he was reducing his sponsorship payments. In the relevant period, the taxpayer had advertised its South West Seafoods brand on, inter alia, players' shirts and the club's website. The taxpayer had also used the club for business hospitality and had helped the club improve its squad of players by with its sponsorship payments which were used to recruit players. A particular benefit to the taxpayer as a result of making the sponsorship payments was that it made it easier to obtain bank funding for the taxpayer's expansion. The taxpayer sought to exclude the payments it had made to the club from the computation of its profits for the purposes of corporation tax. Section 74(1)(a) of the Income and Corporation Taxes Act 1988 precluded the deduction of expenditure which had not been “wholly and exclusively laid out or expended for the purposes of the trade”. The Revenue and Customs Commissioners made assessments to corporation tax which the taxpayer appealed against on the basis that it should be allowed to deduct payments made to the club from the computation of its profits. The payments to the club amounted to £1·2m and the extra tax due if the payments were not deductible was about £300,000. The taxpayer appealed to the First-tier Tribunal (Tax Chamber) (FTT). The FTT decided that improving the financial position of the club had been a conscious purpose in the mind of C and therefore the taxpayer.

It took the view that C had wished to benefit the club so that the taxpayer might benefit in consequence. Applying a restrictive interpretation of the words “wholly and exclusively ... for the purposes of the trade” in s 74(1)(a) of the Act, the FTT concluded that the sums paid by the taxpayer to the club for purposes such as increasing the club's player budget were not deductible for the purposes of corporation tax. The taxpayer appealed to the Upper Tribunal (Tax and Chancery Chamber).

The taxpayer submitted that the FTT had decided that the payments had been made for the benefit of the club in order to benefit he taxpayer. The issue had been about a payment made by one trader (A) to another trader (B) which was for an immediate purpose of benefiting trader B but in order to achieve an ultimate objective of benefiting trader A. It contended that in that situation, the fact that the benefit to trader B was necessarily inherent in the object of furthering the trade of trader A did not mean that the payment was excluded. In that case the ultimate purpose of the payment had been and had always been to benefit the taxpayer. The benefit to the club should been seen as merely a consequential and incidental effect. On that basis, the taxpayer argued that the payment was deductible as a matter of law and the FTT's decision was wrong.

Decision:

The appeal would be dismissed.

It was well established that the “wholly and exclusively” test in s 74(1)(a) of the Act did not set up two categories of purpose – private and business – and provided that everything should be allocated to one or other category. The question was only whether the taxpayer's actual purpose had been exclusively (namely solely) a business purpose. If not then the test was not satisfied.

The decision of the FTT had been correct. The case law showed that the existence of a necessarily inherent objective or result of some activity carried on for another reason did not mean that the activity automatically had two purposes in the relevant sense which would prevent the expenditure from being

deductible. The real question in the case was whether that was what the FTT had held on the facts in the instant case. The judge clearly had in mind the question of whether the fact that it could be said that helping the club had been a means to an end (the end being benefiting the taxpayer) had made helping the club consequential and incidental. The judge had not accepted that they had been. The judge had made a clear finding that C and therefore the taxpayer's subjective intentions had included improving the club's position. It was a finding that had been plainly open to the FTT to make on the evidence. C's conscious purpose of improving the club's financial position had been so that the taxpayer's commercial interests would be furthered in consequence. Both purposes had been in view and therefore the payments had not been wholly and exclusively for the purposes of the taxpayer's trade.

Okolo v Revenue and Customs Comrs [2013] STC 906 applied; Usher's Wiltshire Brewery Ltd v Bruce (Surveyor of Taxes) (1914) 6 TC 399 considered; British Insulated and Helsby Cables Ltd v Atherton (Inspector of Taxes) [1925] All ER Rep 623 considered; Bentleys, Stokes and Lowless v Beeson (Inspector of Taxes) [1952] 2 All ER 82 considered; Vodafone Cellular Ltd v Shaw (Inspector of Taxes) [1997] STC 734 considered; Icebreaker 1 LLP v Revenue and Customs Comrs [2011] STC 1078 considered.

Decision of First-Tier Tribunal (Tax Chamber) [2012]; UKFTT 599 (TC) affirmed.

Comments - Where a company decides to sponsor a sports team, it does not follow that the sponsorship is wholly and exclusively for the purpose of the company's business. Sponsorship may be carried out from altruistic motives (e.g. a desire to improve facilities for young people in the particular locality), or from egotistic motives (e.g. to boost the sponsor's individual profile), as well as simply to advertise the company's business. The First-tier Tribunal held that the sponsorship here had been entered into with a dual purpose, and was not wholly and exclusively for the purpose of the company's trade. The Upper Tribunal upheld this decision as one of fact.

Interfish Ltd v HMRC (Upper Tribunal)

Purpose of legal costs

The taxpayer had been at the material time the owner of an unincorporated car transport business, which included the transport of vehicles from Solihull to the docks at Southampton. In September 2002, a fatal accident occurred in Southampton on 19 September 2002, in which a pedestrian had unfortunately been killed by a vehicle driven by one of the taxpayer's drivers, R. R had eventually admitted to driver error. The taxpayer and his foreman, G, had admitted that a number of vehicle maintenance records had been falsified to cover up the workshop's increasing difficulty in keeping up with the mandatory maintenance programme for his fleet of 18 car transporters. The documents which had been falsified included those relating to a missed inspection in August 2002 of the vehicle which a month later had been involved in the accident. In due course, R was charged with manslaughter to which he had pleaded guilty and had been sentenced to 12 months' imprisonment. The taxpayer and G were each charged with gross negligence manslaughter and two counts of attempting to pervert the course of justice. They both pleaded guilty to the latter charges, but not guilty to the manslaughter charge on the grounds that the accident had been primarily caused by driver error. The first trial took place in December 2003 and resulted in a successful submission of no case to answer on behalf of G. The jury had been discharged, and a second trial had taken place in September to October 2004. The

taxpayer had been acquitted of the manslaughter charge, but sentenced to eight months' imprisonment on the charges to which he had pleaded guilty. He had been legally aided in the second trial, but had been ordered to pay the costs of the first trial, which had totalled £268,672. The taxpayer had claimed that amount as deductions in the accounts of the business for the accounting periods ending 31 August 2003 (£48,752), 2004 (£55,929) and 2005 (£163,991) respectively. The Revenue subsequently opened enquiries into the taxpayer's self-assessment tax returns for the tax years 2003–04 to 2005–06 inclusive, in which deductions had been claimed for his defence costs. Following extensive correspondence between the Revenue and the taxpayer's tax advisers, closure notices had been issued on 20 August 2009 for each of the three years disallowing the expenses and making appropriate amendments to the returns. The taxpayer appealed against the amendments, and his appeal was heard by the First-tier Tribunal (Tax Chamber) (the FTT). The FTT heard oral evidence from the taxpayer and H, a solicitor who at the material time had been employed by F&W (the solicitor's firm instructed by the taxpayer to conduct his defence). The FTT did not accept that the taxpayer's only real concern in defending the criminal charges against him had been the protection of his business and operator's licence. It took the view that the only reasonable conclusion that it could come to on the facts was that the expenditure incurred by the taxpayer should be disallowed as not having been incurred wholly and exclusively for the purposes of his trade, as required by s 34 of the Income tax (Trading and Other Income Act) 2005. On that basis, the expenditure was disallowed and the appeal dismissed. The FTT refused permission to appeal to the Upper Tribunal (tax and Chancery Chamber)(the tribunal), but permission was subsequently granted by the tribunal itself.

The taxpayer submitted, inter alia, that the FTT had erred in law in failing properly to consider the evidence of H. He argued that the only reference in the FTT's decision to H's evidence had been the incomplete summary of it and that no reference had been made to other parts of her evidence, particularly para 10, which had constituted important circumstantial evidence from which inferences could have been drawn about the taxpayer's state of mind at the relevant time.

Decision:

The appeal would be dismissed.

Whether a payment was made exclusively for the purpose of the taxpayer's trade or partly for that purpose and partly for another was a question of fact for the Revenue. The court could interfere only if the Revenue had made an error of law in reaching its conclusion. The court would interfere where the true and only reasonable conclusion from the facts found by HMRC contradicted the determination.

The argument that the FTT had failed to give proper weight to the evidence of H was fanciful. It was under no obligation to set out her evidence at length, and the summary of it in the decision had been perfectly adequate. There was no reason to doubt the assurance given by the FTT, when refusing permission to appeal, that they had taken her evidence into account when reaching its decision; and it had obviously been right to say that H had been in no position to give evidence about the taxpayer's purpose in defending the manslaughter charge. The value of her evidence lay in the explanation of the regulatory background, and the nature of the work that had been done on the taxpayer's behalf. She had been a witness of fact, not an expert witness, and any opinions which she might have expressed about the taxpayer's personal motivation would have been irrelevant. Further, even read at face value, her witness statement did not substantiate the argument that the sole or main focus of the evidence-

gathering exercise conducted by F&W had been the pending inquiry before the traffic commissioner. Accordingly, that ground of appeal represented a groundless attempt to discover an error of law in what had been, in truth, a decision of the facts which the tribunal had been fully entitled to reach.

Comments – The verdict is not really that surprising. It was quite clear from the facts and the the decision in the First Tier Tribunal that there was a duality of purpose and that would be fatal to a claim for deductibility of the expenses.

Duckmanton v CRC, Upper Tribunal

Restriction on relief for uncommercial trades

An accountant (K), who was also a keen runner, was made redundant in 1989. While seeking new employment, he began a small business selling running kit. He opened a shop in 1990. The shop consistently made net losses, for which K claimed relief against his employment income. For 2009/10, HMRC rejected his claim on the basis that K had not met the conditions of ITA 2007 s 66(2)(b), since he was not trading 'with a view to the realisation of profits'. K appealed, contending that the business would be profitable if he could achieve a turnover of more than £28,000, which he still hoped to do.

Decision:

The FTT dismissed K's appeal. Judge Cannan held that s 66 should be construed so that 'a taxpayer is not permitted relief where it is anticipated that at some future date the way in which the business is carried on will or may change, enabling profits to be generated in the future'. He expressed the view that the evidence did not indicate that a turnover of £28,000 was 'reasonably achievable', that K 'must have known that the business could not make a profit until he was able to devote more time to the business', and that K had operated the shop because 'it offered an exit strategy from his job as an accountant'.

Comments - ITA 2007 s 66 provides that 'trade loss relief against general income for a loss made in a trade in a tax year is not available unless the trade is commercial'. The FTT upheld HMRC's contention that the trade had not been carried on 'with a view to the realisation of profits', and was therefore not commercial. ITA 2007 s 66 originally derives from FA 1960. When it was introduced, the then chancellor of the exchequer (the late Derick Heathcoat- Amory) stated that 'we are after the extreme cases in which expenditure very greatly exceeds income or any possible income which can ever be made in which, however long the period, no degree of profitability can ever be reached'. Unfortunately this statement was not cited to Judge Cannan, who has adopted a significantly more restricted interpretation of the provision than the chancellor had promised.

S Kitching v HMRC TC2781

Further reforms to the rules for loans to participators (Lecture B799 – 14.18 minutes)

In his Budget on 20 March 2013, the Chancellor said:

'The Government will consult on options to reform the structure and operation of the tax charge on loans from close companies to make the rules fairer and simpler.'

In FA 2013, three loopholes were duly closed down (see S79 and Sch 30 FA 2013). However, on 9 July 2013, HMRC released a consultation document entitled 'Reform Of Close Company Loans To Participators Rules', in which they confirmed that they intend to undertake a wider review of the 'loans to participators' regime.

It has been pointed out that, in the latest year for which statistics are available (2011), outstanding loans from close companies to their participators amounted to over £1,000,000,000. This suggests that the current rules may not be fully effective as a deterrent against such arrangements.

One of the explanations for the magnitude of this indebtedness is that the tax charge of 25% under S455 CTA 2010, together with what HMRC term the 'mechanistic' repayment provisions, can often produce a lower overall tax bill for the participator, especially when the company recovers the 25% tax on the repayment or write-off of the loan. This means that there is sometimes an incentive to take a loan rather than remuneration or a dividend.

Three options are being considered as an alternative to maintaining the existing status quo:

i. The first possibility is to retain the present system but to increase the charge to, say, 40%.
ii. The second possibility is to make S455 CTA 2010 an *annual* charge so that, where a loan is outstanding over a period of several accounting periods, there will be a levy at the end of each year rather than just the first one. In this case, the rate of tax could be set at a lower level such as 5%. Any S455 CTA 2010 tax would *not* be recovered by the company when the loan was repaid.
iii. The third possibility is to have an annual charge based on the *average* amount of any loan which was outstanding during the accounting period. A key difference, compared with (ii) above, is that there would be no nine-month rule. In other words, a S455 CTA 2010 charge would arise, regardless of whether the loan was repaid during the nine months following the end of the accounting period or not.

HMRC plan that the new rules should operate in relation to loans and advances made on or after 6 April 2014.

Contributed by Robert Jamieson

Taxation of dividends: principles of European law

Advocate general Wathelet has delivered what appears to be an important opinion in Test Claimants in the FII Group Litigation v CIR (No. 3) (Case C-362/12). This case follows on from the CJEU decision in Test Claimants in the FII Group Litigation v CIR (No. 1) (Case C-446/04) [2007] STC 326.

Several UK companies applied to the Ch D for a declaration that the UK corporation tax rules, under which dividends from UK companies were not taxed but dividends from companies resident in other EC Member States were subject to tax, contravened the EC Treaty. The Ch D referred the case to the CJEU, which held that the treaty 'must be interpreted as meaning that, where a Member State has a system for preventing or mitigating the imposition of a series of charges to tax or economic double taxation as regards dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way.

' What is now article 63 of the TFEU 'precludes legislation of a Member State which exempts from corporation tax dividends which a resident company receives from another resident company, where that state levies corporation tax on dividends which a resident company receives from a non-resident company in which it holds at least 10% of the voting rights, without granting the company receiving the dividends a tax credit for the tax actually paid by the company making the distribution in the State in which the latter is resident.' The CJEU also held that 'individuals should have an effective legal remedy enabling them to obtain reimbursement of the tax unlawfully levied on them and the amounts paid to that Member State or withheld by it directly against that tax'. Following this decision, the case was referred back to the Ch D. Henderson J delivered a lengthy judgment, against which both sides appealed. The CA unanimously held that there should be a further reference to the CJEU (see Case C-35/11, reported at [2013] STC 612). The CA also upheld HMRC's contentions that: English law provided a restitutionary remedy for such claims, as applied in Woolwich Equitable Building Society v CIR [1992] STC 657; that such claims were subject to a six-year limitation period; and that HMRC was not precluded from relying upon the curtailed limitation period for mistake-based claims introduced by FA 2004 s 320 and retrospectively extended by FA 2007 s 107. The claimants appealed to the Supreme Court against these parts of the CA decision. The Supreme Court held that there should be a further reference to the CJEU to consider whether European law required only that a Member State must make available an adequate remedy which meets the principles of effectiveness and equivalence; or whether it required every remedy recognised in domestic law to be available so that a claimant could obtain the benefit of any special advantages that this may offer on the question of limitation (in which case FA 2004 s 320 would contravene European law).

Decision:

Advocate general Wathelet expressed the opinion that 'where, under the law of a Member State, a taxpayer can choose between two causes of action in order to claim restitution of taxes levied contrary to articles 49 TFEU and 63 TFEU and one of those causes of action benefits from a longer limitation period, the principles of effectiveness, legal certainty and the protection of legitimate expectations preclude legislation of that Member State, adopted after the claim has been brought, under which that longer limitation period is curtailed without notice and retrospectively'.

Comments - There is a great deal of money at stake in this case. Advocate general Wathelet specifically disapproved the dissenting judgment of Lord Sumption in the Supreme Court, and expressed the opinion that FA 2004 s 320 contravened the Treaty on the Functioning of the European Union.

UK finance company: lease of ship

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

The FTT allowed L's appeal, holding that the ships were used for a 'qualifying purpose' within CAA 2001 s 123(1), and that the restriction imposed by s 123(4) did not apply, so that L was entitled to allowances.

The main issue before the Upper Tribunal was whether the taxpayer was entitled to capital allowances at 25%.

Decision:

The Upper Tribunal upheld this decision (by the casting vote of Newey J, with Judge Nowlan dissenting).

The tribunal decided the ships were used for a qualifying purpose within s 123(1), saying that the qualifying test could be satisfied even “if the operating costs are not entirely met by the ship operator”. Looking at the restriction in s 123(4), the tribunal said “all that s 123(4) requires is that a main object of a relevant transaction was to obtain a writing-down allowance other than an allowance such as s 109 provides for”. The subsection would apply where the main object was to obtain a 25% writing-down allowance, regardless of whether allowances at 10% might have been an alternative. In any event, the taxpayer was claiming capital allowances without regard to s 109, since this section “would have played no part in the determination of the allowance”.

Comments - The Upper Tribunal upheld the FTT decision that the appellant company was entitled to the allowances which it had claimed, albeit only by the casting vote of Newey J. Newey J held that some of the FTT's observations on CAA 2001 s 123 were 'open to criticism', but that the FTT's conclusion was a finding of fact which was not unreasonable. In view of the difference of opinion between the Upper Tribunal judges, it would seem likely that HMRC will seek to take the case to the Court of Appeal.

HMRC v Lloyds TSB Equipment Leasing (No. 1) Ltd (Upper Tribunal)

Company purchasing own shares: whether void

A company (T) was incorporated in 2002. In 2005, there was a disagreement between its shareholders, following which it was agreed that T would purchase the shareholding of its company secretary (B). T made various payments to B without complying with the requirements of the Companies Acts.

Following an enquiry, HMRC issued a formal decision that B had received a distribution of £120,000 from T in 2005/06. B appealed, contending that the agreement between T and B had contravened Companies Act 1985 s 164, and should be treated as void.

Decision:

The First-tier Tribunal (FTT) accepted the latter contention and allowed B's appeal. Judge Poole held that T's acquisition of its shares from B should be treated as void, and that T (which had subsequently gone into administration) was entitled to recover the money which it had paid to B.

Comments - An attempt by HMRC to charge tax on a void transaction found no support at the tribunal .

R Baker v HMRC TC2790

Avoidance scheme involving restricted securities: application of Ramsay principle

A company (T) entered into a tax avoidance scheme, devised by an accountancy firm, involving the award of restricted shares in a subsidiary company to its managing director (L), with the aim of paying him a substantial bonus without incurring any liability to PAYE or NIC. The subsidiary company was subsequently liquidated, and its assets were distributed to L. HMRC issued determinations charging PAYE and NIC.

Decision:

The FTT dismissed T's appeal, specifically distinguishing the Upper Tribunal decision in UBS AG v HMRC (No. 2) [2013] STC 68. Judge Kempster observed that the UBS case 'involved several hundred employees of multinational services companies', whereas in the present case there was 'a very close identity' between T and L, and it was L himself who had decided to implement the scheme.

The only aim was to extract the 'surplus cash' from T, and the only rationale for the subsidiary company 'was to put money in and then strip it out again as soon as possible thereafter'. Applying the principles laid down in WT Ramsay Ltd v CIR [1981] STC 174, the restricted securities and the subsidiary company should be disregarded, and 'the only coherent analysis of the transaction is that the surplus cash of the employer was paid to the relevant employees'.

Comments - There was a great deal of money at stake in this case, which was treated as a lead case for several other companies which have adopted similar schemes. The FTT upheld HMRC's contention that the scheme was within the Ramsay principle, with the result that the interposition of a subsidiary company and the use of restricted securities should be disregarded, and the transactions should be treated as the payment of emoluments which were within the scope of PAYE and NIC.

Tower Radio Ltd v HMRC (and related appeal) TC2784

Business as normal

The taxpayers were companies that operated in the "grey market", that is they sold goods outside the normal authorised distribution channels. They agreed to purchase razor blades from an independent wholesaler, of which they had made enquiries and visited, and sold the razor blades to CEMSA, a Spanish wholesaler. The companies paid the wholesaler for the goods after they had been paid by CEMSA.

The transactions gave rise to substantial input VAT claims, but HMRC refused them on the basis that the transactions were fraudulent and the taxpayers should have known they were connected with fraud.

The First-tier Tribunal dismissed the taxpayers' appeal.

Decision:

The Upper Tribunal said the taxpayers had checked the vendor company and verified that it was engaged in commercial activity. The fact that it had approached the taxpayers was not an unusual occurrence in the grey market. Furthermore, in light of the evidence, the transactions were "entirely explicable as ordinary market transactions". Even if the taxpayers' should have had their suspicions aroused by some of the circumstances, this was not "good enough".

The judge concluded that if the terms of dealing were in line with how business was usually conducted in the grey market, "it can hardly be said that the only reasonable explanation for the circumstances in which the transactions took place is that the transactions are connected with fraud, even if some facets of the transactions might raise a suspicion of fraud".

The taxpayers' appeal was allowed.

Davis & Dann Ltd and another v CRC, Upper Tribunal

Elaborate avoidance

The taxpayer, P&O Steam Navigation Company, claimed double taxation relief of approximately £21m in respect of payments made to it, directly or indirectly, by related companies, on the basis that the payments were all dividends. HMRC amended P&O's tax return to £7m, reflecting the underlying tax that had actually been paid.

The company appealed, saying the effect of TA 1988, s 801 was that the remaining £14m should be recognised as paid.

Decision:

The First-tier Tribunal ruled that, for a double taxation relief claim to be effective, there had to be a payment that could be properly characterised as a dividend, and the claim had to relate to UK or overseas tax paid on the profits represented by the dividend. In this instance, the scheme had been

devised purely to avoid tax. There were no profits on which tax was borne, nor any payment that could realistically be classed as a dividend for the purposes of s 799(1).

The judge, Sir Stephen Oliver QC, said: "the transactions … were all part of an elaborate trick designed to exploit s 801(4A) and (4B) … P&O and its subsidiaries played out a scripted game of charades designed to produce, as an illusion, the requirements for the application of section 801(4B)."

The taxpayer's appeal was dismissed.

Peninsular & Oriental Steam Navigation Company v HMRC TC2725

No evidence to support claim

The taxpayers were in partnership as printers. They incorporated the business in 1998, but retained the partnership, which charged the company rent for use of the business premises.

The original premises were in London N19, but in 2001, the taxpayers bought new premises in London N17. In June 1998, the partners bought a four-bedroom residential house which they sold in June 2006.

The taxpayers said the residential property was used to house specialist staff employed in the printing business and that the staff paid the market rent. It was also let to another printing business, V, for two years and had been used for storage by the taxpayers' printing business. They claimed business asset taper relief on the gain, arguing that the property was a business asset for the entire period they owned it. HMRC refused the claim, although agreed that business asset taper relief applied in respect of the two years while the house was let to V.

Decision:

The First-tier Tribunal found that the taxpayers' claims that the house had been used for business purposes were "contradictory, unsubstantiated by documentation and highly improbable". There was no need to use the property for the business because it was run from dedicated premises elsewhere.

The taxpayers' appeal was dismissed.

Comments – In the light of the Mak case this decision seems strange and contradictory.

A Mateides and H Mateides TC2750

Consultancy Fee Taxability

In early 2004, an opportunity arose for the taxpayer to acquire a business (Transfer Systems International (UK) Ltd (in receivership)) (TSI). A new company (York Place (No 312) Ltd, subsequently renamed Envireneer Ltd (Envireneer) was formed for the purpose of acquiring the relevant trade and assets of TSI and did acquire that trade and those assets in April 2004. Following its acquisition, the taxpayer and D continued its business through Envireneer. The taxpayer was managing director of

Envireneer pursuant to a service agreement dated 1 April 2004 and held 80% of the shares therein. The remaining 20% of the shares in Envireneer were held by D, who acted as finance director. At a board meeting on 10 December 2004, the directors of Envireneer decided that Envireneer could benefit from business development advice. Envireneer therefore decided to appoint a consultant to develop the business and provide strategic advice. Envireneer decided that it wished the taxpayer to carry out that role. The taxpayer agreed to take on the consultancy assignment. At a board meeting of 10 December 2004, the board of directors of Envireneer gave the taxpayer permission to carry out that role on the basis that she would do so through a company. Permission of the board of directors was required in that regard as the taxpayer's service agreement with Envireneer prevented her from working for another company. A contract for the consultancy services was drawn up on 10 October 2005. At that time, the taxpayer's new company had not yet been incorporated. At a meeting of the board of directors of Envireneer in December 2005, an invoice from the then unincorporated company “Torglenn Ltd (Torglenn)” to Envireneer in respect of the consultancy services was tabled in the amount of £2·385m (the consultancy fee) for the year to 31 December 2005 and approved. The directors of Envireneer made a payment in respect of the consultancy fee to Morton Fraser LLP (Envireneer's solicitors) on 30 December 2005 for Morton Fraser to hold for Torglenn. Morton Fraser paid the consultancy fee into its client account and showed it on an Envireneer ledger as a sum appropriated to Torglenn. Once the incorporation of Torglenn had been completed, Morton Fraser held the consultancy fee on its client account for the benefit of Torglenn and subsequently (on 8 January 2007) transferred that sum to Torglenn's bank account. Torglenn was subsequently incorporated on 4 January 2006 in Guernsey. A contract was concluded between Envireneer and Torglenn on 10 January 2006 for Envireneer to engage Torglenn to provide services to Envireneer from the commencement date of 4 January 2006. On 22 September 2006, a further contract was concluded between Envireneer and Torglenn. Torglenn reported the consultancy fee as income in its accounts and United Kingdom corporation tax return for the period ended 31 December 2006 and paid corporation tax thereon. The Revenue and Customs Commissioners (the Revenue) opened an enquiry into Envireneer's corporation tax return for the period ended 31 December 2005, in particular in relation to the consultancy fee paid to Torglenn. Ultimately, the Revenue issued a closure notice on 4 February 2010 with no amendment to the corporation tax deduction which had been claimed by Envireneer in respect of that payment. The Revenue contended that the consultancy fee fell to be taxed as the taxpayer's self-employed trading income and raised a protective discovery assessment for 2005/06 on 15 March 2010 in the amount of £979,751·60 (representing the income tax and class 4 national insurance contributions which according to the Revenue arose on the consultancy fee of £2·385m in respect of tax year 2005/06) and a further protective discovery assessment for 2004/05 on 22 March 2011 in the amount of £253,670·59 (representing the income tax and class 4 national insurance contributions which according to the Revenue arose on £614,219 of the consultancy fee of £2·385m in respect of the tax year 2004/05). The taxpayer appealed against both the 2005/06 and 2004/05 discovery assessments and full postponement of the tax was applied for. The appeal and postponement application was acknowledged by the Revenue and the postponement application agreed.

The overarching issue, as ultimately presented on behalf of the taxpayer was whether by the application of generally accepted accounting practice, as provided by s 5 of the Income Tax (Trading and Other Income) Act 2005, the consultancy fee had constituted “profits from a trade profession or vocation” which the taxpayer had been entitled to receive. In other words, whether a notional trading and profit and loss account in her name as an individual, for the tax year (or years) in question, would have included a credit entry in the profit and loss account for the amount of the consultancy fee.

Decision:

The appeals would be allowed.

The substance and commercial effect of the arrangements had been that the taxpayer would never be entitled to payment of the consultancy fee. She had to incorporate a company. It had been within her power to do so and she had eventually done so. Torglenn had requested payment of the consultancy fee and Envireneer had paid Torglenn: Torglenn had accepted payment. There was never any intention that the taxpayer would have any entitlement qua individual to the fee. No right to the consultancy fee had ever been created in her favour. She had not received the fee; she had not demanded it to be paid to her; it had not been offered to her and it had not been paid to her. At no stage had she had control over the money which the consultancy fee had represented. If the substance and commercial effect of the arrangements had been as stated, then generally accepted accounting practice would not require the taxpayer to recognise the consultancy fee as her income. None of the actings of any of the participants and none of the documents produced, indicated expressly or by implication, that there had been an agreement between any combination of those participants that the taxpayer should be, or be treated as having become, entitled to the consultancy fee.

Greene King Plc v Revenue and Customs Comrs [2012] UKFTT 385 (TC) considered

Comments – Clearly HMRC perceived the arrangements as ones where the timing worked to the taxpayer's advantage and the sums were so significant that the challenge was inevitable. However the decision made it clear that the taxpayer would never be entitled to the payment of the consultancy fee in their individual capacity. The right decision was therefore made and demonstrates that even in the present environment properly constructed and legal tax planning will work.

Re Hepburn [2013] All ER (D) 29 (Sep)

Effective set-off

In March 2001, the claimant, Ardagh Group, sold the share capital of one of its subsidiary companies (Y) to the defendant, Pillar. Under the agreement, Pillar would pay £2.2m on completion and a further amount calculated in accordance with clause 6 of the agreement. This clause concerned the potential use of capital losses suffered by Ardagh to reduce taxable profits or gains.

In December 2009, HMRC made an agreement with Y for the set-off of Y's accrued losses against profits of other companies in the Pillar group. Ardagh then claimed that this triggered the obligation to pay further consideration in clause 6. Pillar refused to pay, arguing that the losses were not an "effective set-off" within the sale agreement because the agreement with HMRC was part of a wider agreement involving additional liabilities.

Decision:

The Court of Appeal said "allowable capital losses" in clause 6 should be interpreted as losses of Y allowable for capital gains tax purposes. The set-off was effective when HMRC agreed the losses. There was nothing in the agreement that indicated the nature of the evaluation exercise submitted by Pillar.

Ardagh's appeal was allowed.

Comments – This demonstrates the need for clarity in an agreement to ensure that the right tax consequences follow.

Ardagh Group SA v Pillar Property Group Ltd EWCA

Are trading losses allowable? (Lecture B798 – 13.06 minutes)

Restrictions on losses

The rules on restrictions to loss relief are contained in ITA 2007, Part 4 Ch 2. Section 64 allows the offset of trade losses against general income; however, s 66 says that such relief is not available unless the trade is commercial.

Section 66(2) says a trade is commercial if it is carried on throughout the basis period:

- on a commercial basis; and
- with a view to the realisation of profits.

Section 66(3) says that "If at any time a trade is carried on so as to afford a reasonable expectation of profit it is treated as carried on at that time with a view to the realisation of profits."

A taxpayer is not permitted relief where it is anticipated that at some future date the way in which the business is carried on will or may change, enabling profits to be generated in the future. The taxpayer cannot rely for the purposes of loss relief under ITA 2007, s 64 on a change in the way a business is carried on after the end of the basis period.

Commercial business

There are special rules for farming losses at ITA 2007, s 67 to s 70. Broadly, they prevent the offset of losses against general income after five years unless a competent farmer could not have reasonably expected the activities to become profitable until later.

Relief for trade losses in the first four years, provided by ITA 2007, s 72, is restricted by ITA 2007, s 74 in that the trade must be carried on in such a way that profits could reasonably be expected within a reasonable time.

FA 2013, s 16 and Sch 3 now provide further restrictions on loss relief; although the policy reason for the £50,000 cap on loss offset is rather harder to discern than are the reasons for restrictions on hobby or uncommercial trades.

If HMRC conclude that there is a risk, then the officer will, as well as looking at the actual calculation of the loss, ask whether:

- there is a trade at all;
- it is the claimant's trade; and
- the trade is commercial.

BIM75705 goes on to say:

"Fact-finding is vital in exploring whether the trade is carried on on a commercial basis.

"Ideally the officer would want to meet the taxpayer. While many advisers suggest clients think carefully before meeting HMRC this might be the kind of issue where the right client could convince the officer that his business answers these questions satisfactorily. This is particularly true in farming cases where a site visit may allay concerns."

Whose trade?

Who owned the trade in question was an issue in *JCL Agnew v HMRC* (TC566). Mr Agnew claimed losses, largely due to wages paid to his wife, in a manicurist's trade. The decision of the First-tier Tribunal shows that it is not enough to assert the claimant is the trader. While the wife gave all of the treatments and dealt with the bookings, running the business in her name, the appellant's role was limited.

Is the trade commercial?

In the *JCL Agnew* case mentioned earlier, the tribunal held that even if he had been trading, Mr Agnew's business structure was uncommercial; it could never generate profit. The payments to his wife, were clearly out of all proportion to the sales being achieved.

View to the realisation of profits

In such fact-dependent cases, the impression the taxpayer makes on the tribunal can often be crucial as was the case in *Kerr (Re Grantham House) v Revenue & Customs* (TC917). Mr Kerr took on the lease of a National Trust property at £45,000 per annum. He spent about £22,000 on repairs and wages. His plan was to make profit from opening the house and grounds to visitors. He opened the property for two days in late 2006, but no paying customers attended and his total sales were £80. Yet the tribunal concluded that he was trading, the trade was commercial and carried on with a view of profit.

Another reason for the losses?

In Wannell v Rothwell reasons were identified, apart from the profit motive, for people being in business. Many viable trades are founded on the personal interests of the trader. But if the business structure is inherently unprofitable this will often be because the trade is really just a hobby or subsists to support a personal interest.

Summarised from an article in Taxation by Iain Macleod of EDF Tax Ltd

VAT

Education: definition of 'eligible body'

A company (L) provided computer tuition. Initially, it accounted for VAT on its supplies, but it subsequently submitted a repayment claim on the basis that it should have treated them as exempt supplies of education. HMRC rejected the claim on the basis that L was not an eligible body. L appealed, contending that it had an 'articulation agreement' with Middlesex University and should therefore be treated as a college of that university.

Decision:

Both the FTT and the Upper Tribunal dismissed L's appeal, holding that L had not in fact qualified as an 'eligible body'.

Comments - The Upper Tribunal (comprising Judge Hellier and Judge Bishopp) upheld the First-tier decision that the college was not an 'eligible body', so its supplies failed to qualify for exemption. However, although Judge Hellier and Judge Bishopp arrived at the same conclusion, they did so by somewhat different routes. In the FTT, Judge Walters had expressed the view that the relevant arrangements could have been capable of constituting the company as a college of Middlesex University, if significantly more of its students had proceeded to courses at that university. Judge Bishopp disagreed with this, holding that there was nothing in the articulation agreement 'which could conceivably be construed as being intended to constitute (L) as a college of the university'. Judge Hellier held that the company did not 'have objects similar to the aims of a public body supplying school or university education or vocational training'.

London College of Computing Ltd v HMRC (Upper Tribunal)

Wetland sites: whether a 'zoo'

The Wildfowl and Wetland Trust appealed against an assessment, contending that seven of the nine sites which it operated qualified as zoos for the purpose of VATA 1994 Sch 9 Group 13 Item 2. The FTT allowed the appeal in principle.

Decision:

Judge Raghavan observed that the Oxford English Dictionary defined a zoo as 'a place where wild animals are kept for breeding, study or exhibition to the public'. Each of the seven sites was a place 'where wild animals are kept for public exhibition', and qualified as a zoo.

Comments - The FTT upheld the trust's contention that seven of the sites which it operated (including the well-known nature reserve at Slimbridge) qualified as a zoo for the purposes of VATA 1994 Sch 9 Group 13 Item 2.

Wildfowl & Wetland Trust v HMRC TC2817

Whether leaseback transaction was an 'abusive practice'

A university, which was partly exempt, implemented a scheme with the objective of recovering the whole of the input tax incurred in refurbishing a derelict mill (which it opted to tax). The scheme involved the creation of a discretionary trust, the grant of a 20-year lease of the mill to the trust, and a leaseback by the trust to the university. The creation of the trust and the grants of the lease and underlease all took place on the same day. Customs issued an assessment on the basis that the lease and leaseback were not effective for VAT purposes (so that most of the input tax should be attributed to the university's exempt supplies). The university appealed.

The VAT tribunal referred the case to the CJEU (Case C-223/03) [2006] STC 980, which held that 'the question whether the transaction concerned is carried out for the sole purpose of obtaining a tax advantage is entirely irrelevant in determining whether it constitutes a supply of goods or services and an economic activity', although 'the Sixth Directive precludes any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice'. The CJEU held that the transactions in question constituted supplies of goods or services and an economic activity provided that 'they satisfy the objective criteria on which those concepts are based, even if they are carried out with the sole aim of obtaining a tax advantage, without any other economic objective'.

Decision:

Following the CJEU decision, the FTT reheard the case and allowed the university's appeal. Judge Demack held that the leaseback arrangement had not been abusive, applying the principles laid down by the CJEU decision in HMRC v Weald Leasing Ltd, (Case C-103/09) [2011] STC 596.

Comments - The FTT rejected HMRC's contention that the scheme adopted in this case, involving the creation of a discretionary trust and a leaseback arrangement, was an 'abusive practice'. HMRC has already appealed to the Upper Tribunal against this decision. Gary Barnett (senior PSL, tax, Simmons & Simmons), said: 'Two aspects of the case are likely to be the focus of HMRC's appeal. First, the tribunal's assessment of the scheme as only a VAT deferral scheme with a built-in feature that allowed an absolute VAT saving at a later date will no doubt be attacked by HMRC, given the finding of the tribunal that it accepted that "from the outset it was the university's intention to make an absolute tax saving". HMRC may well argue that this feature of the scheme should be regarded as sufficient to make it contrary to the purposes of the VAT rules from the outset. Second, the tribunal rejected the argument that the university's intentional use of an unconnected trust as lessee, rather than a subsidiary, to prevent the application of the UK's anti-avoidance provisions which would otherwise have disapplied the option to tax, was sufficient to engage the principle of abuse of law. In Weald Leasing, the CJEU indicated that the involvement of an intermediate third party might be sufficient to engage the principle of abuse, where the involvement of the third party was to prevent the application of domestic anti-avoidance provisions which would have required VAT to be accounted for on arm's length values. Accordingly, HMRC may well wish this issue to be reconsidered on appeal.'

University of Huddersfield Higher Education Corporation v HMRC (No. 2) TC2823

Supplies of locum doctors

A company (R) supplied medical doctors to hospitals on a locum basis. HMRC issued a ruling that it was required to account for tax on its supplies. R appealed, contending that its supplies should be treated as exempt under VATA 1994 Sch 9 Group 7 item 5.

Decision:

The FTT rejected this contention and dismissed the appeal. Judge Herrington held that item 5 had to be interpreted in accordance with article 132(1)(c) of Directive 206/112/EC, and that R's services did not amount to 'medical care' within article 132(1)(c). Item 5 had to be given 'a conforming construction so that it is consistent with the UK's obligation not to grant an exemption which goes beyond the permitted scope of the exemption in article 132(1)(c)'. Therefore, item 5 should be construed as referring to 'the provision of medical care services provided by a deputy', rather than simply to 'the provision of a deputy'.

Comments - This is an important victory for HMRC because the FTT accepted that, on a literal construction of the UK legislation, the company's supplies qualified for exemption. However, the tribunal upheld HMRC's contention that the UK legislation should not be read literally, but that the scope of the exemption should be restricted by treating the UK legislation as if it included additional wording to bring the scope of the exemption into line with the wording of Directive 2006/112/EC. It has for many years been accepted that a taxpayer can rely on the provisions of an EC Directive to override the UK legislation, but this appears to be the first case where that principle has been applied in favour of HMRC, denying the taxpayer the benefit of an exemption which the UK legislation, read in isolation, would appear to provide.

Rapid Sequence Ltd v HMRC TC2826

The 'taxable amount'

A company which traded as a travel agent granted customers discounts from the prices originally charged by tour operators, and claimed that these discounts should be deducted in computing the taxable amount. The tax authority rejected the claim, the company appealed and the case was referred to the CJEU.

Decision:

Advocate general Wathelet delivered an opinion in favour of the company, applying the principles laid down in Elida Gibbs Ltd v C&E Commrs [1996] STC 1387.

Comments - The UK case of Tui Travel PLC v HMRC is currently under appeal to the Upper Tribunal, and has been stood over pending the CJEU's decision in this case. The advocate general's opinion appears to increase the company's prospects of success.

Finanzamt Düsseldorf-Mitte v Ibero Tours GmbH (CJEU Case C-300/12)

'Contract purchase agreement': time of supply

A company (M) sold motor vehicles under a 'contract purchase agreement' which gave customers the option of purchasing or returning the vehicle at the end of the agreement. In accounting for VAT, M treated the agreement as a rental agreement with an option to purchase, so that the payments under the agreement were consideration for supplies of services and VAT was chargeable at the time each payment was made. HMRC issued assessments on the basis that M was making supplies of goods, so that VAT was chargeable on the full consideration at the beginning of the agreement.

Decision:

The FTT dismissed M's appeals, holding that the agreements fell within article 14(2)(b) of Directive 2006/112/EC. Judge Tildesley held that each agreement was 'a contract for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment'.

Comments - The FTT upheld HMRC's contention that the company was making supplies of motor vehicles and was required to account for VAT on the full consideration at the time of the contract. Commenting on the decision, Shimon Shaw (Matthew Arnold & Baldwin) said: 'The tribunal agreed with HMRC's contention that “in the normal course of events” directs attention to what is provided for in the contract, not on the wider circumstances, i.e. was the passing of ownership normal under the terms of the contract, rather than abnormal? The fact that ownership might not transfer did not preclude it from being a contract for sale, since ownership would normally pass under its terms.'

Mercedes Benz Financial Services Ltd v HMRC (No. 2) TC2778

Option to tax golf course: whether binding on partnership

A married couple acquired a farm in 1967. In 1987, they arranged for a newly incorporated associated company to convert part of the farmland into a golf course. In June 1990, the couple registered for VAT as a partnership, and opted to tax the golf course. In February 1991, the couple entered into a partnership agreement with their two sons to operate a golf club on the course. In 2001, a VAT officer inspected the partnership records and formed the opinion that the partnership had failed to abide by its option to tax the golf course. HMRC issued a ruling that the option was irrevocable. The partnership appealed, contending that the option had only been made by the couple who owned the land, and did not bind the separate partnership formed in 1991 which included their sons.

Decision:

Judge Green rejected this contention and dismissed the appeal, but the Upper Tribunal remitted the case for rehearing by a different judge. At the rehearing, Judge Sinfield upheld Judge Green's decision, finding that the golf course had been an asset of the partnership at the time the election was made.

Wrag Barn Golf & Country Club v HMRC (No. 3) TC2802

The principle of 'abuse'

An accountancy firm advised a group of companies to enter into a complex scheme with the intention of only accounting for VAT on its profit on 'demonstrator cars', rather than on their full sale price. Four associated 'dealership' companies sold various 'demonstrator cars' to three associated 'captive leasing companies' under leaseback arrangements. The 'captive leasing companies' assigned the benefit of the lease agreements and the underlying cars to a Jersey bank (S), in return for a substantial 45-day loan facility. A month after these transactions, another associated company (PD) entered into an agreement with S to acquire its car hire business. This was treated as a transfer of part of S's business as a going concern, and therefore as outside the scope of VAT. PD then sold the cars to arm's length customers under the second-hand margin scheme, only accounting for VAT on its profit margin. HMRC issued assessments on the basis that the scheme was an 'abuse', applying the principles in Halifax PLC v C&E Commrs. They also imposed misdeclaration penalties. The companies appealed. The First-tier Tribunal reviewed the evidence in detail and allowed the appeals. Judge Shipwright observed that the accountancy firm 'seemed to think it was selling a means of reducing VAT on demonstrator cars which also involved the provision of third party finance'. However, the subjective aim of the accountancy firm was not conclusive. The main aim of the holding company's finance director was to ensure that its 'continued funding needs were met'. Viewed objectively, the principal aim of the transactions was 'the obtaining of finance', rather than 'an abusive VAT advantage'. The Upper Tribunal reversed this decision.

Decision:

The CA unanimously restored it. Lloyd LJ held that Judge Shipwright had been entitled 'to come to the conclusion that no element of the arrangement was inserted artificially, and that the arrangements were not abusive or artificial'.

Comments - The CA restored the FTT decision in favour of the company, holding that the FTT had been entitled to find that the appellant company had a legitimate commercial aim in entering the relevant transactions, notwithstanding that the accountancy firm which devised the scheme had 'seemed to think it was selling a means of reducing VAT on demonstrator cars which also involved the provision of third party finance'. As Stephen Herring has observed, the case appears to illustrate the distinction between 'understandable tax planning undertaken as part of a commercially driven transaction and blatant "standalone" planning approaches which are not derived from the commercial transaction itself'.

Pendragon PLC v HMRC (and related appeals) (CA)

Zero rating conundrum

The taxpayer, a property developer, converted a pub into two semi-detached houses and sold them. The company claimed input tax in relation to the conversion on the grounds that the sales were zero rated supplies under VATA 1994, Sch 8 group 5 item 1(b). HMRC refused the claim, saying the sales would be exempt. This was because the pub had incorporated a manager's flat, parts of which would have been incorporated into each of the semi-detached houses.

The taxpayer appealed.

Decision:

The legislation in Sch 8 group 5 note (9) states: "The conversion, other than to a building designed for a relevant residential purpose, of a non-residential part of a building which already contains a residential part is not included within items 1(b) or 3 unless the result of that conversion is to create an additional dwelling or dwellings." The First-tier Tribunal decided that the creation of the additional dwelling by the company meant that note (9) did not prevent the conversion falling within item 1(b).

The appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said that when a horizontal conversion is carried out on a commercial property which contains a residential dwelling, creating for example a ground floor and lower floor flat, "this will result in one exempt sale and one zero-rated sale (the existing flat conversion being an exempt sale), but a vertical project, such as the construction of two semi-detached houses, creates two zero-rated sales and therefore full input tax recovery on related costs. To further cloud the waters, in the case of a DIY claim in the latter situation, ie for a non-business project, VAT can be partly claimed on the costs of converting the non-residential part of the building into the houses, but not in relation to work on the existing first floor, which is already residential. Who said that VAT is a simple tax?"

Alexandra Countryside Investments Ltd TC2751

Inaccuracies not all deliberate

In April 2008, the management committee of a mosque claimed, on behalf of the taxpayer, input tax of £36,747 in respect of the construction costs of the mosque. HMRC said the input tax claimed was not recoverable because no business activity was taking place. It was later agreed that 65% of the claim could be attributed to business use. Alternatively, the mosque could deregister from VAT and claim a refund of VAT under the DIY builders scheme.

The mosque wished to remain registered but did not immediately proceed with its input VAT claim based on 65%, in the hope that it might be possible to claim 100% of the input tax. Eventually, because of a lack of response from the mosque, in April 2009 HMRC reduced the claim to nil.

In its return for the period to April 2010, the mosque claimed input tax of £42,214. This included the original £36,747 input tax that HMRC had disallowed.

HMRC disallowed the claim and imposed a penalty for a deliberate inaccuracy. The inspector said the management committee could have been more helpful in quantifying the error.

The taxpayer appealed.

Decision:

The First-tier Tribunal decided a penalty was justified. It found that the mosque committee was confused as to the basis of the claim, but that HMRC had tried to be helpful and outlined the alternatives in a straightforward way. The tribunal divided the claim into two: the 65% claim and the remaining 35% claim. It concluded that the committee believed its adviser when he said that the 65% claim should be made in the April 2010 return and this amounted to a careless inaccuracy. With regard to the 35% claim, this was deliberate on the basis that the committee must have known, from the correspondence with HMRC, that it was not entitled to the amount claimed.

The taxpayer's appeal was allowed in part.

Comments - Neil Warren, independent VAT consultant, said: “There have not been many tribunal appeals since the new penalty system for correcting errors was introduced in April 2009; overall, HMRC appear to have been very fair in applying the regulations as to what errors are careless, deliberate or concealed. In this case, the tribunal was persuaded by the fact that the management committee had largely been led by advice from the external accountant acting for the charity, and also the very technical nature of the VAT issues, which it would not be expected would be understood by volunteer committee members.”

Bilal Jamia Mosque v HMRC TC2727

Handy quirk

The taxpayer carried on in business as a restaurant. It was registered for VAT between 2006 and 2008, when it deregistered because its turnover fell below the registration threshold. On 17 November 2011, the taxpayer notified HMRC that it should be registered for VAT from March 2011. After checking the business's turnover figures for the period from April 2010 to November 2011, HMRC said the business should have registered for VAT again from November 2010.

HMRC imposed a penalty on the taxpayer for late registration of VAT. They noted that the omission to notify was not deliberate and disclosure had been unprompted, but because the disclosure was more than 12 months late, the penalty would be between 10% and 30% of the potential lost tax. They imposed a penalty of 10%.

The taxpayer appealed. It argued that the penalty is calculated according to when the VAT “first becomes unpaid by reason of the failure” to disclose (FA 2008, Sch 41 para 13(5)(a). HMRC stated that the disclosure was more than 12 months after this time, but the taxpayer said the earliest time the tax would have become due was 31 December 2010, which was less than 12 months.

Decision:

The First-tier Tribunal judge agreed with the taxpayer and went so far as to say: “If the disclosure had been made later (eg in January 2012), we would have required evidence as to the length of the first VAT

accounting period which would have been allocated to the appellant on registration, in order to clarify the actual first due payment date of VAT."

The taxpayer's appeal was allowed and the penalty mitigated by 100%.

Comments - Neil Warren, independent VAT consultant, said: "The taxpayer's advisers have identified a very useful quirk in the legislation by challenging the concept of when 'tax first becomes unpaid' and the outcome of this case could be useful when a taxpayer is seeking to reduce a time based penalty in similar circumstances. It will be interesting to see how HMRC react to this case. However, it potentially makes penalty calculations much more complex, because a penalty cannot just be based on the relevant percentage of the tax due on the return for the late period."

Taste of Thai Ltd TC272)

VAT disclosure was prompted

HMRC had contacted the taxpayer (the United European Gastroenterology Federation) on 30 March 2010 to arrange a visit to its UK accountants to review a repayment claim of £150,000 relating to the December 2009 return. However, one day before the scheduled visit (20 May), the accountants contacted HMRC to alert the officer to potential errors and asked for the meeting to be rearranged. The accountants had identified errors on three VAT returns, and underpayments of £699,822, when year-end accounts were being completed.

The issue was whether the disclosures were "prompted" as the result of an intended HMRC compliance visit or "unprompted", ie the taxpayer had disclosed the errors without any reason to know that HMRC had discovered or would discover the errors.

The taxpayer argued that it was work on the accounts that led to errors being identified, rather than any additional checking process carried out as a result of the intended HMRC visit.

The minimum penalty for a "prompted" careless error is 15% (ie £104,973) as opposed to a 0% penalty for an unprompted disclosure. The taxpayer also argued that the penalty should be treated as a "suspended penalty", which HMRC felt was inappropriate.

Decision:

The tribunal held that an unprompted disclosure could only apply if the taxpayer had "no reason to believe" that HMRC had discovered or were about to discover the inaccuracy. Once the officer had made contact regarding a review of the records, the taxpayer had at least some reason to believe the inaccuracy would be discovered. The taxpayer lost the appeal.

Comments - Neil Warren commented: "There have been relatively few tribunal cases concerning the 'careless error' penalty regime introduced in April 2009, which suggests that HMRC have applied the legislation very sensibly in most cases. Another problem for the taxpayer in this case was that its VAT

registration in the UK related to a one-off conference event (after which it deregistered) so there was little scope to argue that a suspended penalty would be appropriate."

United European Gastroenterology Federation TC2698

Retrospective flat rate scheme

The taxpayer, Geoffrey Seefe t/a TPL Associates, registered for VAT on 2 January 2007 as a management consultant, but did not apply to join the flat rate scheme (FRS) because he expected the value of his taxable sales in the next 12 months to exceed the scheme limit of £150,000 (VAT exclusive). However, his optimism was unjustified and his highest annual turnover in the first five years of trading was £49,000.

He deregistered on 31 December 2011 and, at the same time, requested that he be allowed to join the FRS retrospectively back to 2007 and recalculate his VAT liability. He claimed that the dramatic decline in his business turnover after the financial crisis of 2008 was an "exceptional circumstance", which meant that he should be allowed to join the scheme. The net tax saving in the five-year period would be £2,151 under FRS, compared to normal VAT accounting. HMRC refused the request for a retrospective joining date.

Decision:

However, the tribunal was not satisfied that HMRC had considered all of the specific circumstances raised by the taxpayer that made his circumstances "exceptional" and had refused his request on the basis of standard policy. The taxpayer's appeal was allowed.

Comments - Neil Warren said: "This verdict is controversial because the taxpayer's motive for joining the scheme retrospectively was to reduce his tax liability and, because the aim of the scheme is to save time rather than tax, such a request invariably fails. However, HMRC's internal guidance requires that 'each case should be considered on its own merits' by the reviewing officer, that 'all relevant facts must be considered', and that policy was not followed in this case. To quote from the report: 'It is a case where reasonable expectations proved unforeseeably to be catastrophically wrong, to the extent that the appellant fell far short of the threshold for registering for VAT at all, and where the appellant is now suffering considerable financial hardship.'"

Geoffrey Seefe T/A TPL Associates TC2738

Assets or business?

In May 2011, the taxpayer, HQ, bought printing machinery and office equipment from Nowelle. The latter was about to go into liquidation and was majority owned by HQ. Nowelle included VAT in the price of the assets sold to HQ which reclaimed the VAT as input tax.

HMRC refused the claim, saying the sale constituted a transfer of a going concern. The taxpayer had many of the same customers as Nowelle, and operated from the same premises. Most of the employees had previously been employed by Nowelle and the director had also been a director of Nowelle.

The taxpayer appealed, saying it had not purchased Nowelle's business, just assets.

Decision:

The First-tier Tribunal found that printers and office equipment were transferred to the taxpayer from Nowelle. In addition, 15 of Nowelle's 22 employees began work with the taxpayer, which operated from Nowelle's premises. Many clients moved across to the taxpayer.

The combination of these factors led the tribunal to conclude that the transaction amounted to the transfer of Nowelle's business as a going concern and was outside the scope of VAT. On that basis, the supply of machinery and equipment from Nowelle to the taxpayer should not be treated as a supply of goods or services.

The taxpayer's appeal was dismissed.

Comments - The taxpayer also argued that Nowelle had accounted for and paid output tax of £13,000 and therefore it would be incorrect for HMRC to disallow the input tax claimed by HQ, otherwise HMRC would be unjustly enriched. Neil Warren, independent VAT consultant, said: “There is no statutory requirement for HMRC to adopt this approach and Nowelle owed over £9,000 of VAT. The transfer of a going concern rules can be a very grey area of the VAT legislation and a key approach is to remember that substance over form is the relevant consideration.”

HQ Graphics Ltd TC2640

Self-billing problem

The taxpayer, a scrap metal business, had used a self-billing system with suppliers for many years. HMRC were aware of the arrangements, although had not formally sanctioned them, having carried sundry VAT inspections at the business. The company would ask for a copy of the supplier's VAT registration certificate and, having obtained it, call the local VAT office to check the document was correct. Having done that, the taxpayer made no further checks on the supplier.

It transpired that four of the suppliers had subsequently deregistered, which led HMRC to refuse to allow input tax claimed by the company in respect of suppliers from those traders.

The taxpayer appealed, saying that HMRC should use their discretion permitted under VAT Regulations 1995, reg 29 to consider the claim. HMRC refused because the conditions for self-billing arrangements had not been met by the taxpayer.

Decision:

The First-tier Tribunal said that HMRC were "fully aware" that the taxpayer was using self-billing arrangements. The tribunal judge did not accept HMRC's contention that the taxpayer could have known that the suppliers were deregistered. He was satisfied that the managing director of the company had spoken to the VAT office which had confirmed the suppliers were registered. The invoices that were subject of the appeal were correctly completed and complied with reg 14 and the VAT legislation. The tribunal concluded that HMRC had acted unreasonably in not exercising their discretion.

The taxpayer's appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said: "Self-billing is very common in many trades, but the conditions specified in the legislation and HMRC's policy guidance need to be closely followed. If the taxpayer had ensured a self-billing agreement was in place with each supplier, the assessment considered in this case would have been unlikely to have been raised. The agreement would have specified that the supplier must notify the company if it deregistered for VAT purposes, which would, it is hoped, have avoided this problem."

GB Housley TC2548

Lease of nursing home: whether separate supply of facilities

A company (SN) operated a nursing home. In 2003, the ownership of the premises was transferred to a newly incorporated associated company (SC), which leased them back to SN. SC subsequently reclaimed input tax on the refurbishment of the premises. HMRC rejected the claim, on the basis that the input tax was wholly attributable to exempt supplies. SC appealed, contending that it was making separate standard-rated supplies of facilities, in addition to its exempt supplies of a lease of the premises.

Decision:

The First-tier Tribunal rejected this contention and dismissed the appeal, holding that SC was making a single composite exempt supply of property and services, and that none of the input tax was attributable to taxable supplies.

Comments - The First-tier Tribunal upheld HMRC's contention that the scheme which the company had adopted was ineffective and that it was not entitled to reclaim any of the input tax on the refurbishment of the nursing home.

Sunnyside Property Company Ltd v HMRC TC2839

Curtains drawn on VAT

The taxpayer bought a secondhand curtain shop in May 2000. She took over the VAT registration of the previous owner because her acquisition of the business was a transfer of a going concern. Trading went well until July 2008 when she fell ill and she had to close the shop in December.

She submitted a form VAT 7 applying to cancel her VAT registration, stating that she expected her taxable supplies to be worth £20,000 in the year to December 2009.

In July 2010, the taxpayer began a new business selling furniture on commission. Her turnover was below the VAT registration threshold.

HMRC said they did not receive her application to cancel her VAT registration and, even if they had, they would have refused it because there were outstanding VAT returns. The taxpayer appealed.

Decision:

The First-tier Tribunal found that it was not reasonable for HMRC not to be satisfied that the taxpayer was not liable to be VAT registered from December 2008. The HMRC officer at the hearing accepted that there was no legislation preventing HMRC from cancelling a VAT registration if VAT returns were outstanding from the date cancellation was requested. The department furthermore acknowledged that she "may have ceased to have a liability to be registered for VAT on 20 December 2008".

Turning to whether the taxpayer had in fact applied to cancel her VAT registration, the tribunal concluded, on the balance of probabilities, that she submitted the form in December 2008 and was entitled to deregister from that date.

The taxpayer's appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said submitting VAT 7 forms online to HMRC would prevent the problems which occurred in this instance from arising. He said electronic submission "ensures there will be no future issues with missing post or lost paperwork; the computer gives a submission reference number after the form has been submitted providing reassurance to the taxpayer that the deregistration request has been received by HMRC".

D La Roche (TC2758)

Application for judicial review of ruling that supplies exempt from VAT

A limited liability partnership (G) had reclaimed input tax relating to its supplies of pathology services. In 2013, HMRC issued a ruling that the effect of the CJEU decision in L.u.P. GmbH v Finanzamt Bochum-Mitte, [2008] STC 1742, was that the supplies were exempt under VATA 1994 Sch 9 Group 7 Item 4. G appealed, and also applied for an injunction preventing HMRC from implementing the ruling pending the hearing of its appeal, contending that previous rulings which HMRC had issued in 2008 and 2010 had given it a legitimate expectation that it could reclaim input tax.

Decision:

The QB granted an interim injunction. Leggatt J held that, as a matter of UK law, it appeared that the services were simply the provision of information which G's customers could use for therapeutic purposes, and were not themselves exempt. He described the CJEU's reasoning in L.u.P. GmbH v Finanzamt Bochum-Mitte as 'opaque'. He also held that the reasoning expressed in HMRC's decision letter 'could not command confidence'. The implementation of HMRC's ruling would have serious financial effects on G and, if it were applied retrospectively, it would render G insolvent. Furthermore, this was not a case where G had 'withheld any relevant information or failed to put their cards face up on the table when they requested a ruling'. It appeared that there had been 'a change in the personnel within HMRC responsible for dealing with (G)'. It would be 'wholly unreasonable to expect the claimants to restructure their business before the true legal position has been established by the decision of the tribunal'. Therefore, 'the balance of convenience clearly favours granting an interim injunction so as to preserve the status quo in terms of tax treatment until after the tax appeal has been determined'.

Comments - The QB accepted the partnership's contention that previous HMRC rulings had given it a legitimate expectation that it could reclaim input tax relating to its supplies, and that it would be unfair for HMRC to treat the supplies as exempt before the First-tier Tribunal had decided the partnership's appeal.

R (oao GSTS Pathology LLP) v HMRC (and related applications) (No. 1), QB [2013] EWHC 1801 (Admin)

The option to tax anti-avoidance rule (Lecture B800 – 10.30 minutes)

Within the option to tax legislation there is an anti-avoidance rule which can catch clients unaware.

Example

Consider a dental practice that wishes to buy a newly constructed property for £400,000 plus VAT. If the partnership bought the property the input tax of £80,000 would be irrecoverable as they are an exempt business.

They have been advised to buy the property in a company which would then opt to tax the property and grant a lease to the dental practice. The company would recover the VAT on the property purchase as the costs incurred relate to taxable rental income. The lease would be at market value so they accept that the dental practice would suffer the VAT on the lease rentals just as if they were letting from an unconnected landlord.

Due to the anti-avoidance rules within Schedule 10 Paragraph 12 the company's option to tax would unfortunately be disapplied. The rental income would then be exempt and as a consequence the company would not be able to recover VAT on the purchase. If they have done so then this would be an error and penalties may apply.

The anti-avoidance test is explained very clearly in VAT Notice 742A paragraph 13 and is as follows:

1. Is the property within the capital goods scheme?

The property is bought for £400,000 plus VAT and as this is greater than £250,000 plus VAT (CGS limits) it will be within the capital goods scheme.

If it is within the capital goods scheme we must then consider Test 2. If it is not within the capital goods scheme then the anti-avoidance rule would not apply.

2. At the time for grant (of the lease) does the grantor or financier expect non-qualifying use by the grantor, financier or a connected person (s.1122 CTA 2010) within the next 10 years?

Non qualifying use will be more than 20% exempt activity or usage by a person who is not registered for VAT.

If test 2 is met then the option to tax is disapplied.

In the dentists case they will be connected parties i.e. a company owned by the partners. As such the grantor (the company) expects exempt use by a connected party (dental partnership). The option to tax is disapplied.

Example

Consider a firm of financial advisors who wish to buy a new office building for £450,000 plus VAT for their own occupation. They have not always used their annual £50,000 pension contribution limit so this year the three partners have each paid £80,000 into their pension fund with a view to the pension fund buying the property and leasing it to the partnership. The pension fund has cash reserves but will also seek bank funding to secure the purchase.

After securing the property the pension fund will opt to tax and charge VAT on the rental income. The pension fund is expecting to recover VAT on the property purchase as the purchase relates to taxable rental income.

Unfortunately the IFA practice is likely to be regarded as the financier by way of their pension contribution. The contributions will not cover the whole purchase price but that is not relevant – financing can be in whole or part. The key is that they helped provide the funds (via their pension contribution) with the expectation that their funds would be used to buy a property which they would then occupy for exempt purposes.

At the time of grant the financier expects exempt use by the financier and as a result the option to tax is disapplied.

Example

Consider a father who has owned a shop in the high street for the past four years.

Since the father bought the shop he has had a tenant who has run a coffee shop from the premises. The father opted to tax the property as soon as he bought it and was able to recover the £60,000 VAT paid on purchase.

The tenant is moving out and the father's daughter has expressed an interest in running a tea shop from the premises. The father is keen to help and has agreed to let the shop to his daughter for the same rent as he charged the previous tenant.

The daughter does not expect to exceed the registration threshold of £79,000 in the first few years and will delay registering for VAT until she has to. Her advisor has checked that s.49 VATA 1994 does not apply to the daughter – primarily because the coffee shop tenant was not VAT registered either.

This all sounds great but the father's advisors need to explain the impact of the daughter's occupation to him. At the time of grant of the lease to his daughter he is expecting non-qualifying usage (unregistered) by a connected party (his daughter). His option to tax will be disapplied and he will have an exempt source of rental income. This rental income will create unwelcome capital goods scheme adjustments of approximately £6,000 per annum for the next six years!

Letting to the unregistered coffee shop tenant was fine as they were not connected.

Letting to his daughter would be fine if she was registered for VAT – still connected but the use will be qualifying use.

The law supporting the anti-avoidance rule is within VATA 1994, Schedule 10 but readers would be well advised to consider VAT Notice 742A Para 13 as this provides a good explanation of how HMRC see the law applying.

Contributed by Dean Wootten