Tolley®CPD

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Personal Tax

Mistake over encashment of insurance policies

In March 2007, the taxpayer invested £120,000 in a Sterling Investment Bond. The bond was divided into 1,000 separate insurance policies and partial encashments were permitted. Soon afterwards, the taxpayer requested a partial repayment of £60,000 by surrendering equally from each individual contract in the bond. He ticked a box to request this method, but later said this was an mistake on his part. A few days later, he withdrew a further £20,000.

The taxpayer did not mention the partial surrenders on his 2007/08 tax return.

In September 2011, HMRC informed the taxpayer that he received a taxable gain arising on chargeable events from the policy and assessed him to tax on £74,000, ie £80,000 less the £6,000 tax-free amount available at the rate of 5% of the original investment.

The taxpayer appealed, saying the gain arose because of mistakes in the partial surrender instructions. He sought to rectify the errors to restructure the surrenders so as not to incur the tax charge.

Decision:

The First-tier Tribunal referred to Lobler (TC2539), a similar case where the tribunal had no choice but to find for HMRC. The judge said he could "only echo and respectfully agree with the analysis in that decision". The tribunal had no power to set aside and change a transaction "simply because one of the parties to the transaction has realised that he made a mistake which he now seeks to correct".

The result may be repugnant, but no other conclusion was possible.

The taxpayer's appeal was dismissed.

Comments – This the second case in a relatively short period involving the consequences of the wrong method of surrendering investment bonds. It is yet another demonstration of the unnecessary and sometimes unfair application of the tax legislation if one is not aware of the quirks of the legislation. This must surely be a candidate for simplification.

R Downward TC2905

Legal costs not allowable against employment income

The taxpayer was employed by Calyon (now Crédit Agricole Corporate and Investment Bank) as its "global head of exotic interest rate derivatives risk management". He appealed against his unfair dismissal from the company on 31 July 2008, having complained that the company had promoted a French national and that this was an act of discrimination.

The Employment Tribunal agreed and awarded compensation, although this was reduced on appeal and the taxpayer had to pay his own legal costs as well as £66,000 of Calyon's — a total of £263,761.

The taxpayer claimed a deduction for these legal costs against his earnings for 2010/11. This was refused by HMRC who issued a closure notice under TMA 1970, s 28A and increased his income tax liability by £49,136.

Decision:

Unsurprisingly, the First-tier Tribunal dismissed the taxpayer's appeal on the basis that the costs were not allowable under ITEPA 2003, s 336. This required that the costs should be paid “as holder of the employment” and should be incurred “wholly, exclusively and necessarily in the performance of the duties of the employment”.

Comments – The decision was self-explanatory in that for costs to be allowable against the income from an employment the costs have be incurred wholly, exclusively and necessarily in the performance of the duties of the employment. They were not. The test in s 336 is stringent; even legal costs incurred in successfully fighting a claim for unfair dismissal are not deductible.

Michael Wardle TC2986

Residency: NO 'distinct break' from UK

Mr and Mrs Rumbelow contended to have ceased being UK resident on 4 April 2001. Following the Supreme Court's decision in Gaines Cooper , the tribunal had to decide whether a 'distinct break' in the pattern of their lives had taken place, relying on a multifactorial enquiry. It was established that Mr R had wanted to retire from his property business and that the Rumbelows had hoped that the slower pace and better weather of Portugal would suit them. However, following changes in Portugal's tax law, they had been advised to take up residency in Belgium first.

On 4 April 2001, in what seemed a rather precipitated move governed by a desire to have become non-resident by the start of 2001/02, they left the UK in a car packed with suitcases and personal belongings and drove to Belgium without having arranged for accommodation. They subsequently acquired a property in Portugal in 2002. Their youngest daughter (aged 15) had refused to accompany her parents and so arrangements had been made for her care in the UK. The evidence suggested that the Rumbelows had spent a considerable amount of time in the UK after 4 April 2001, staying with their daughter in the family home, and that their stays in Portugal were more akin to 'extended holidays during the winter months'. In that respect, it was clear that they had treated the advice they had received rather casually.

Decision:

The tribunal concluded that the 'loosening of ties was not sufficiently substantial' to establish the loss of UK residence.

Comments - Since the beginning of the tax year 2013/14, the statutory residence test applies when determining the residence of an individual. However, this case will be relevant when establishing loss of UK residency in previous tax years.

Stephen Norman Rumbelow v HMRC TC3022

Residency: 'distinct break' from UK

The taxpayer claimed to have ceased to be UK resident at the beginning of the tax year 2004/05. He had arranged for the disposal of assets held in a substantial property company which he co-owned with his brother. The disposal was to trigger a substantial dividend and so loss of UK residence was crucial. However, the tribunal pointed out that the tax purpose of the appellant's move only fitted 'neatly' with his wish to sever completely any ties with his business and to live a more healthy lifestyle in Monaco. The key question (following Gaines-Cooper) was whether Mr Glyn had established a 'loosening' of his ties with the UK substantial enough to establish a distinct break. As it had always been his intention to return to the UK with his wife and to occupy the family home again in the distant future, the family home had been kept and was constantly occupied by a housekeeper. The tribunal accepted that such a substantial property could not be left empty. At the centre of HMRC's case was the fact that the taxpayer had visited London frequently (although less than 65 days a year) since purportedly becoming non-resident and that during those frequent but very short visits, he had enjoyed spending Jewish holidays, including Friday nights, with his wife and children in the family home.

Decision:

The tribunal rejected HMRC's argument: 'Surely … if a person has left the UK, and he then makes periodic visits back to the UK those visits are likely to be for some special event or some purpose that is of some significance to him.' Moreover, the tribunal accepted the appellant's contention that he had settled in Monaco. He had acquired a very comfortable and luxuriously furnished apartment and enjoyed all that his new lifestyle offered him; walks to the beach, short trips to the South of France, attending the grand prix, etc. Having noted that the appellant spent three times more days every year in Monaco than in the UK and that he had substantially loosened not only business ties but also social and family ties with the UK, the tribunal concluded that Mr Glyn had established a distinct break.

Comments - This case may be relevant to taxpayers who claim to have ceased to be UK resident before April 2013 (when the statutory residence test came into effect). It suggests that keeping a residence in the UK is not necessarily fatal.

James Glyn v HMRC TC3029

Director's personal liability for company's unpaid NIC

A company went into liquidation in 2007, having failed to pay national insurance contributions of more than £320,000. HMRC issued a notice under SSAA 1992 s 121C to the company's finance director, ruling that he should be liable for paying the majority of the unpaid contributions. The director appealed, contending that he had not been guilty of any 'neglect', so that the condition laid down by s 121C(1)(b) was not satisfied. At a preliminary hearing, the First-tier Tribunal held that 'neglect' should be construed subjectively, so that it should consider medical evidence about the director's mental capacity.

Decision:

The Upper Tribunal reversed this decision. Hildyard J held that the question of 'neglect' had to be construed objectively, and remitted the case to the First-tier Tribunal for rehearing.

Comments - The Upper Tribunal reversed the First-tier decision and held that, for the purposes of SSAA 1992 s 121C, 'neglect' had to be interpreted as requiring an objective test rather than a subjective test.

HMRC v O'Rorke (Upper Tribunal)

Disposal of employee shares and adviser negligence

Mr Stratton had acquired shares in his employer company and subsequently disposed of them on the sale of the company to a consortium. At the time of the sale, he had been advised by the management of the company that the sale would trigger income tax, and PAYE and NIC had duly been deducted. However, following the advice of his accountant, Mr Stratton had recorded the sale in his tax return, declaring the corresponding income but claiming a deduction for the same amount so as to reduce the chargeable PAYE to nil. He had also declared a capital gain on the sale of the shares.

Under ITEPA 2003 ss 422–424, if the shares had been acquired by reason of Mr Stratton's employment and on terms that made his interest 'only conditional', profits made on the sale of the shares were chargeable to income tax (and not capital gains tax). It was clear that Mr Stratton had acquired the shares by reason of his employment; the letter sent by the chief executive of the company offering the shares to Mr Stratton had stated that the opportunity was offered because Mr Stratton had completed six months' employment. Furthermore, the shareholding deed executed at the time of the acquisition of the shares provided for certain circumstances in which Mr Stratton would have to dispose of his shares. His interest was therefore 'only conditional'. The position was not changed by the fact that a 'director' of the company could exercise his discretion to lift the compulsory sale provisions.

Decision:

The First-tier Tribunal found the taxpayer's adviser to have been negligent (applying an objective test) in claiming a deduction for expenses when none had been incurred, in failing to consider the relevant ITEPA 2003 provisions and in failing to query the reason for the PAYE deduction.

Finally, the tribunal found that, although following the advice of a tax adviser can sometimes constitute a reasonable excuse, this could not be the case when there was 'no reasonable basis' for the advice. The return was therefore negligent.

Comments - The case is a useful reminder of the way the ITEPA 2003 provisions work when an employee disposes of shares. It also suggests that taxpayers should ensure that the advice they receive has 'a reasonable basis', another term for 'filing position'. Without it, they could be held negligent.

Peter Stratton v HMRC TC2967

Payment to settle court proceedings: deductible from consideration for shares?

A public company (G) had acquired the share capital of another public company (P) in 2000. P's chairman (M) had owned a substantial shareholding in P and, following the takeover, he received consideration valued at more than £33m. In 2002, M transferred much of this consideration (shares and loan notes) into a trust, giving rise to a CGT liability. Meanwhile, G had formed the opinion that a profit forecast which M had provided during the takeover negotiations had been misleading. G began court proceedings against M, alleging fraudulent misrepresentation and seeking damages of £132m. In 2006, M and G agreed an out-of-court settlement, under which M paid G £12m plus legal costs of £5.7m. M claimed that these sums should be deducted from his CGT liability for 2002/03. HMRC rejected the claim and M appealed, contending that the payments related to a 'contingent liability in respect of a warranty or representation made on a disposal', within TCGA 1992 s 49(1)(c), and were deductible under s 49(2).

The First-tier Tribunal allowed the appeal in part, and both sides appealed to the Upper Tribunal.

Decision:

The upper Tribunal allowed HMRC's appeal and dismissed M's cross-appeal. Lord Glennie held that 'what the court has to assess in the case of a contingent liability in respect of a warranty or representation made on a disposal by way of sale is whether the liability is directly related to the value of the consideration received by the taxpayer on the disposal of the property'. On the facts here, M's liability arising from the representations he had made in his capacity as P's chairman was 'wholly distinct from the consideration received by him for his shares'. Neither the payment of £12m, nor the associated legal costs, qualified as a 'contingent liability' within s 49. (The First-tier Tribunal's decision had been anonymised. The Upper Tribunal rejected an application for its hearing of the appeals to take place in private. Lord Glennie held that 'the court will not depart from the principle of open justice simply to save one or other party from embarrassment'.)

Comments - The Upper Tribunal upheld HMRC's contention that the payments which the former chairman had made to the purchasing company did not fall within TCGA 1992 s 49, and were not deductible from the consideration which he had received for the sale of his shares. The Upper Tribunal also held that there were no grounds for holding the appeal in private, or for anonymising the decision.

HMRC v Sir AF Morrison (and cross-appeal) (aka B Nevis v HMRC) (Upper Tribunal)

Employee Financed Retirement Benefit Schemes (EFRBS)

HM Revenue & Customs (HMRC) is writing to customers giving them an opportunity to settle open enquiries into the use of EFRBS arrangements by agreement and without needing to engage in litigation. This offer is intended to minimise costs for customers and HMRC.

Customers have until **31 December 2013** to consider the proposals made in the letter and to indicate whether they wish to take advantage of the options offered.

If they do, any settlement between them and HMRC will be concluded by **30 June 2014**.

In conjunction with the opportunity HMRC has provided a range of frequently asked questions (FAQs) designed to help customers understand how the terms of the opportunities apply in practice to the arrangements customers have entered into.

PSAs – A Look Back and Forward (Lecture B807 – 11.20 minutes)

The PAYE Settlement Agreement (PSA) it's an extremely helpful planning tool. Together with dispensations and trivial benefits, they can help to eliminate the need to complete many forms P11D and sometimes tax returns for employees.

Overview

The original PSA legislation took over from an informal scheme known as the Annual Voluntary Settlement (AVS).

There is agreements were reached with an individual Inspector of Taxes who could bring into play any benefit that would normally have to be included on a P11D and taxed on the employee via his or her tax return.

When the new PSA legislation was introduced, the circumstances in which such agreements could be operated were severely limited. They can only be used for benefits that are small, irregular or impossible to divide up actually between individual employees.

The legislation governing is included in Part 6 (Regulations 105 – 117) of the Income Tax (PAYE) Regulations 2003 – SI 2003 No 2682. This allows an employer to settle tax liabilities of employees that come into either the following categories:

(a) taxable benefits provided or made available by reason of employments with the employer, or

(b) expenses paid to persons holding those employments.

The HMRC website explains what can and cannot be included within a PSA.

Items that can be covered by a PSA

To be included, expenses and benefits must fall into one of the following three groups:

- minor items, such as a small present for an employee in hospital or an employee's use of a pool car where the conditions for tax exemption don't apply
- irregular items, such as expenses of a spouse occasionally accompanying an employee abroad, or relocation expenses in excess of the £8,000 tax exemption threshold
- items it's impracticable to operate PAYE on or determine a value for P9D or P11D purposes, such as shared benefits (like shared cars or taxi journeys, for example) that are difficult to attribute to individual employees

Items that can't be covered by a PSA

HMRC won't include any of the following items in a PSA:

- cash payments - including salary, wages, bonus, or other payments such as long service awards
- large benefits provided regularly to individual employees, such as company cars or beneficial loans
- round-sum allowances - lump sums provided to an employee to take care of all their expenses in a tax year
- shares
- items on which tax has already been deducted through PAYE
- items which are already reflected in an employee's tax code
- profits arising from various mileage payment schemes and other regular items arising in Employee Car Ownership Schemes

Operation

Under a PSA, an individual's employer undertakes to settle income tax and NIC on specifically agreed benefits or expenses on behalf of their employees.

In theory, it is necessary to determine the tax rate for each and every employee covered by the agreement. In practice, HMRC is usually willing to accept an averaged rate based on historical empirical evidence.

The tax is calculated on a grossed-up basis and, in addition, Class 1B NIC is payable. This means that the employer effectively pays almost exactly the same amount of money as if they had given the employee a bonus with which to settle his or her own liability.

There is still plenty of scope for uncertainty over which benefits can and cannot be included in a PSA. For example, the most popular P11D item of all is probably the provision of private healthcare insurance.

The Tax and NIC Treatment

1. Work out the total value of the expenses and benefits (inc VAT)
2. Ascertain or estimate proportion of employees in each tax band
3. Calculate total tax due
4. Gross up
5. Work out Class 1B NIC at 13.8% on
   - PSA items
   - Grossed-up tax

Deadlines

It is possible to apply for a PSA at any time but if it is in place prior to the start of a tax year all expenses and benefits can be included. Otherwise, it cannot extend to items on which PAYE has been operated or benefits already reflected in employees' PAYE coding notices.

The absolute deadline is 6 July following the end of any tax year. The liability must then be paid by the next 19 October.

The Proposal

The arbitrary restrictions which prevent so many employers and their staff from utilising PSAs fully should be removed forthwith.

It is hard to see the reason why any benefit, even a car, yacht or house should not be included.

This would drastically reduce the number of P11Ds that have to be completed by many companies.

Contributed by Philip Fisher

Capital Taxes

Simplifying IHT charges on trusts (Lectures P807/ P808 – 19.37/ 17.50 minutes)

On 31 May 2013, HMRC published a consultation document entitled 'Inheritance Tax: Simplifying Charges On Trusts – The Next Stage'. The scope of the paper was explained by them as follows:

'This consultation proposes changes to the way IHT trust charges are calculated. It sets out options on how IHT periodic and exit charges on trusts that hold or dispose of relevant property can be simplified. The consultation also seeks views on proposals to align payment and filing dates for these charges and examines the treatment of accumulated income.'

Simplifying the IHT calculations

It is well known that the calculation of IHT charges under the relevant property regime depends upon a number of factors which can give rise to complex and onerous computations. The Government acknowledge that these calculations can be time-consuming and, for smaller trusts, disproportionately complicated compared to the tax which is typically at stake.

One of HMRC's proposals is that historical information such as the market value of trust property on the date when it was settled can be ignored. In addition, the settlor's cumulative total of chargeable transfers effected in the seven years prior to the making of the settlement will be disregarded and it will no longer be necessary to take into account the value of any property in a related settlement (ie. other property which was settled on the same date but in another trust). In return, a flat tax rate of 6% is being suggested for all exit and 10-yearly charges and the benefit of the IHT nil rate band will have to be shared equally between each relevant property trust created by the settlor.

A comparison of the tax results under the current rules and under HMRC's proposed alternative is set out in (e) below. The illustration looks at a 10-year anniversary charge and assumes that the 2013/14 IHT rates will remain in place for the foreseeable future. Exemptions and reliefs are ignored.

<u>Illustration</u>

Christopher, whose cumulative total stood at nil, settled property worth £100,000 on a discretionary trust on 1 June 2003 (Trust 1). 10 years later, the value of the relevant property is £240,000.

On 1 June 2005, Christopher created two separate settlements, each with property valued at £180,000. One was a discretionary trust (Trust 2) and the other was an interest in possession trust (ie. a related settlement). The value of the property in Trust 2 on the 10-year anniversary date is £400,000.

Current rules

The IHT payable in connection with the 10-year anniversary charge on Trust 1 is nil. Christopher had no previous chargeable transfers at the time when Trust 1 was set up and the value of the trust assets on 1 June 2013 was below the IHT nil rate band.

As far as Trust 2 is concerned, Christopher's cumulative total of chargeable transfers on 1 June 2005 was £100,000 and the value due to be taxed 10 years later is:

	£
Value of Trust 2 property	400,000
Add: Initial value of related settlement	180,000
	£580,000

Using 2013/14 lifetime rates, the IHT on £580,000 is:

	£
On 100,000 – 325,000 = 225,000 @ 0%	–
On 325,000 – 680,000 = 355,000 @ 20%	71,000
	£71,000

The effective rate is:

71,000/580,000 x 100 = 12.241%

The actual IHT liability is:

12.241% x 30% = 3.672% x £400,000 =	£14,688

Proposed alternative

The value of the relevant property in Trust 1 on the 10-year anniversary date is £240,000. However, because Christopher has created two relevant property trusts, the IHT nil rate band limit of £325,000 must be halved.

Thus the value charged on Trust 1 is £240,000 – £162,500 = £77,500. Given that the rate will be 6%, this produces:

6% x 77,500 = £4,650

The value of the relevant property in Trust 2 on the 10-year anniversary date is £400,000. Thus the value charged on Trust 2 is £400,000 – £162,500 = £237,500. This gives rise to a tax liability of:

6% x 237,500 = £14,250

As can be seen, the aggregate IHT liabilities amount to £4,650 + £14,250 = £18,900, compared with the £14,688 which would be payable under the current system.

Aligning filing and payment dates

As HMRC say:

'IHT payment and filling dates can appear confusing and illogical. The time limits for reporting a periodic or exit charge differ from the time limits for paying any IHT due.'

It should be borne in mind that the normal time limit for reporting details of an IHT charge is 12 months from the end of the month in which the transfer is made, whereas the due dates for paying IHT are:

(i) for any chargeable event taking place between 6 April and 30 September (inclusive), tax is due on 30 April in the following year; but

(ii) for any chargeable event taking place in the second half of the tax year, tax is due six months after the end of the month in which the event took place.

Thus it is possible for IHT to be due and payable before the required date for delivering an IHT return. For example, if a trust's 10-year anniversary fell on 14 September 2013, any tax would be due on 30 April 2014 but the return would not have to be filed until 30 September 2014!

HMRC want to align the IHT filing and payment dates with those which apply under the self-assessment framework for income tax and CGT. That is to say, the submission of IHT returns will be required by 31 October following the end of the tax year in which the exit or 10-year anniversary charge arose. Payment of the relevant IHT would follow three months later, ie. on 31 January.

At present, trustees are not obliged to calculate the IHT due when filing their returns. They can ask HMRC to calculate the tax for them. This is going to change. In future, trustees will be required to self-assess any IHT due, with form IHT100 being appropriately adapted to include a 'tax due' box at the end of the return.

This realignment will only apply to exit and 10-year anniversary charges. It will *not* affect other IHT charges such as the entry charge for a newly created settlement or the charge on a deceased person's estate.

Accumulated income

Many settlements have the ability to accumulate undistributed trust income. At the point when such income is accumulated, it is treated as an addition to the trust capital and so must be taken into account when considering, for example, a 10-year anniversary charge.

If income is regularly accumulated, there is little doubt about the correct IHT treatment within the context of relevant property tax charges. However, it can be different where income remains undistributed for lengthy periods and the trustees have not sanctioned any formal accumulation. Of course, where there is a discretionary trust and the trustees have a duty to accumulate income without any power to distribute, income will be treated as accumulated as and when it arises, but it is much more common for discretionary trustees to have a power both to accumulate income and to distribute it and, in such cases, the trust deed rarely stipulates the point when accumulation must take place. Nor is there a statutory rule.

Accordingly, HMRC intend to clarify the treatment of accumulated income by:

(i) making express provision in the legislation that income which is accumulated and added to capital becomes relevant property for IHT trust purposes at that point; and
(ii) deeming income arising in a trust where the trustees have a power to accumulate to be added to trust capital at the start of the second tax year following the year of receipt.

The deeming provision will not apply if the income has already been formally accumulated by the trustees on an earlier occasion. Thus discretionary trust income received on 3 June 2008 and not otherwise distributed will be deemed to have become capital on 6 April 2010.

Some thoughts on these proposals

The consultation document has come in for considerable criticism in the months since it was published. Understandably, most attention has been focused on the decision to split the IHT nil rate band between all the relevant property trusts created by the settlor instead of continuing with the present system under which most trusts are entitled to a full IHT nil rate band of their own. If the legislation is amended next year on these lines, the recast regime will apply to *all* settlements (and not just new ones) from a given date in 2014.

This proposal is clearly intended to counter the established practice of setting up multiple pilot trusts to which substantial property may be added in due course (eg. on death) in order to minimise IHT charges on the trusts going forward. It should be noted that the Court of Appeal recognised this procedure in *CIR v Rysaffe Trustee Company (CI) Ltd (2003)*. In addition, Para D26.6.1 of the GAAR Guidance confirms that the use of pilot trusts is 'not regarded as abusive'.

The CIOT's comments on this revision are very pertinent:

'It is clear that the HMRC proposals represent a fundamental change of direction, ie. to reverse the effects of the *Rysaffe* case. We doubt whether pilot trusts are used as widely as HMRC suggest, but, whenever there is a perceived problem, the approach should be to address it honestly, head-on, rather than to hide behind a pretext of "simplification". The unhappy experience of the pre-owned assets tax regime illustrates only too graphically the difficulties of adopting an indirect solution to a problem.'

The principal problem with the idea of a shared IHT nil rate band is that, in most cases, it will be difficult for trustees to know with any certainty how many other relevant property trusts the settlor has created – remember that there is no intention of having a de minimis rule here, unlike the position with the annual CGT exemption for trusts.

In addition, there does not appear to be any suggestion that the IHT nil rate band should be prorated to take account of the level of funds within each of the trusts. So, if, for example, an individual has set up five pilot trusts with £10 and has then added £149,990 to one of the trusts, the IHT nil rate band will have to be divided equally between the five trusts (giving them each £65,000). As a result, four of the trusts which only contain cash of £10 may waste a substantial proportion of their IHT nil rate bands and the trust containing £150,000 will have £85,000 of value potentially exposed to IHT.

Another difficulty is that the information gathering exercise of determining how many trusts have been created by the settlor will not be a one-off operation – it will have to be repeated on each chargeable occasion, with what the CIOT call 'obvious time and cost consequences'.

A very real concern is that the latest set of proposals will, in the main, give rise to higher tax charges, in particular where the settlor has created several settlements. The CIOT make the following point:

'It is a major failure of the consultation paper that it did not contain more extensive financial modelling to explore alternative approaches and that the Tax Impact Assessment failed to provide any indication of the likely yields under the HMRC model. If a consultation on "simplification" is to have credibility, the outcome must be demonstrably revenue-neutral.'

With regard to the rule under which undistributed income is deemed to be accumulated after two years, the following scenario can be envisaged: a trust holds substantial undistributed income which has built up over a number of years, but none of this has been formally accumulated by the trustees. If a distribution of income is then made, what is it that is being paid out? Is it the income which is deemed to have been accumulated under the two-year rule (now capital) or is it the more recently received income? The Tax Faculty's solution is to have a 21-year rule in place of the two-year arrangement.

Contributed by Robert Jamieson

The impact of S162B IHTA 1984 (Lecture P806 – 15.34 minutes)

In a surprising announcement which appears to be an attack on what has hitherto been regarded as relatively unaggressive and sensible tax planning, the Treasury confirmed in FA 2013 that the rules governing deductible liabilities for IHT purposes have been significantly tightened.

The anti-avoidance legislation covers several aspects of the IHT code, but this chapter focuses on S162B IHTA 1984 which deals with liabilities incurred to finance (directly or indirectly) what is referred to as 'relievable property', ie. property qualifying for any of the following reliefs:

(i) business property relief;
(ii) agricultural property relief; or
(iii) woodlands relief.

If a liability has been incurred to acquire, maintain or enhance property which is eligible for business property relief under S104 IHTA 1984, it is provided that this liability reduces the value of the relevant business property (rather than any other property on which the loan may be specifically secured) so that only the net value of the property attracts business property relief. This puts a stop to the widespread practice of borrowing against the collateral of (typically) a valuable main residence and using the loan proceeds to acquire an AIM portfolio which, in two years' time, should qualify for 100% relief.

There are similar restrictions for the other two reliefs.

It was originally intended that this measure would apply to transfers made on or after 17 July 2013. In practice, this would normally catch deaths occurring on or after the commencement date, despite the fact that the deceased might have implemented his borrowing arrangement several years earlier. In some cases, the taxpayer could have found that his business needed further working capital in order to survive the recession, but the bank would often have been unwilling to make him an appropriate business loan. As a result, he subsequently offered the bank his house as collateral for, say, the £250,000 (which of course they accepted). This arrangement would be caught in exactly the same way as the AIM investment referred to in (c) above. Accordingly, the Exchequer Secretary to the Treasury made the following announcement during the Committee Stage debates:

'The Government recognise that some lenders may require security in the form of personal assets before they are willing to lend and that individuals may not be able to restructure the loan or unwind the arrangements for some time. An amendment will therefore be tabled to change the commencement date so that the new rules dealing with liabilities incurred to acquire a relievable property will apply only to new loans taken out on or after 6 April 2013. That will mean that the new provisions will not affect someone who took out a business loan in the past secured against their other assets.'

This is a welcome amendment. Para 5(2) Sch 36 FA 2013 provides that loans taken out before 6 April 2013 will not be caught, even if the borrower dies on or after 17 July 2013. However, the amendment does *not* apply to any other part of the new IHT rules (eg. S162A IHTA 1984).

The following planning points should be noted in connection with the restriction:

(i) S162B IHTA 1984 will not be in point where a taxpayer mortgages his private residence and uses the proceeds to make a PET to, say, his son. Even if he survives the necessary seven years so that the gift is definitively exempt, the loan deduction will still be allowed against the value of the property on his death.

(ii) Consider another situation: a husband borrows £1,000,000 charged on his main residence in order to purchase an AIM portfolio. Three years later, he gifts the portfolio to his wife. The liability remains outstanding. On his death, he leaves the house to his daughter. Given that he no longer owns relievable property and has not transferred it by means of a chargeable transfer (the gift to his wife was exempt under S18 IHTA 1984), the normal rule in S162(4) IHTA 1984 will then apply and the loan will be deducted from the value of the house passing to the daughter. Of course, the husband might have transferred the AIM portfolio to his wife before it attracted business property relief. In that case, the arrangement would still be tax-efficient because there would have been no transfer of 'relievable property'.

(iii) Suppose that an elderly client decides to do an equity release scheme with his main residence. There are two main types of arrangement:
- a lifetime mortgage; and
- a home reversion plan.

If the proceeds of a lifetime mortgage are used to purchase AIM shares, it is clear that this will be caught by S162B IHTA 1984. However, what about someone who undertakes a home reversion plan, ie. where that person sells his house to a financial institution in return for a lump sum, but with the proviso that he is allowed to remain in the property until he dies (usually on a rent-free basis)? If the proceeds in this case are invested in AIM shares, it does not appear that the arrangement falls within S162B IHTA 1984 given that there is no borrowing.

Contributed by Robert Jamieson

Losses on disposal of real estate in another member state

An individual resident in Finland had made a loss on the disposal of a property situated in France. Under the France/Finland double tax treaty, the disposal of real estate is taxable in the country where the real estate is situated. As the loss was not connected to a trade and profession and the individual did not own any other property in France, he argued that the loss was definitive in France and that he should be allowed to set if off against gains made on the disposal of securities in Finland.

Decision:

The CJEU accepted that a loss triggered on the disposal of Finnish real estate would have been available to offset against gains realised in Finland and that, therefore, the situation constituted a breach of the principle of free movement of capital (TFEU articles 63 and 65). The court also rejected arguments put forward by the Finnish government to the effect that the sale of Finnish real estate and the sale of French real estate by a Finland resident individual were not objectively comparable. The breach could therefore only be justifiable by an 'overriding reason in the public interest', more precisely in this instance, the 'cohesion of the tax system'. It requires a direct link between a tax advantage and the offsetting of that tax advantage by a tax levy, so as to ensure a 'balanced allocation of the power to impose taxes'. This was clearly the case here, as the France/Finland double tax treaty provided that the gain was taxable solely in France and so the loss should also be relievable solely in France.

Comments - The case is a useful reminder of the potential disadvantage for individuals of owning real estate in several tax jurisdictions, as it may not be possible to set off losses and gains made on disposals.

Re K v Finnish Government (C-322/11)

IHT: different treatment of residents and non-residents

A property situated in Germany was part of the estate of a Swiss national. Her widower, also a Swiss national, had been assessed to German inheritance tax, without the benefit of the €500,000 tax-free allowance which would have been available had he or the deceased been resident in Germany.

Mr Welte appealed the assessment on the ground that the relevant provision of German law was in breach of the principle of freedom of movement of capital (article 56 of the TFEU) and the case was referred to the CJEU for a preliminary ruling.

Decision:

The CJEU noted that legislation which reduces the value of an inheritance can be in breach of article 56. The issue was therefore whether German residents and non-residents were in 'objectively different situations'. The German government submitted that a German resident would have been taxed in Germany on the totality of his estate, whereas a nonresident was only taxable in Germany in relation to immoveable property situated there. The CJEU noted, however, that the amount of tax payable on property situated in Germany was calculated exactly in the same way for residents and non-residents and so there was no justification for applying a different allowance for residents and non-residents.

The CJEU also rejected arguments that overriding reasons in the public interest justified the difference of treatment between residents and non-residents. The court pointed out that the advantage conferred to German residents was not offset by any particular charge in Germany, and that the effectiveness of fiscal supervision would not be affected if the German tax authorities had to obtain the information necessary to grant the allowance from heirs or from other tax authorities under bilateral agreements.

Comments - This case should be relied upon in situations where EU taxpayers are subject to a higher level of inheritance tax than nationals of another EU state in relation to the same EU asset. In certain situations, it may also be possible to argue that the current UK legislation, which caps exempt transfers between spouses when the recipient is not UK domiciled, is in breach of article 56.

Welte v Finanzamt Velbert (C-181/12)

Annual tax on enveloped dwellings – an unexpected pitfall (Lecture B808 – 7.31 minutes)

The first ATED returns were due to be submitted on 1 October 2013, with the tax being payable no later than 31 October 2013. Until recently, most companies have focused on:

(i) obtaining a valuation for the property which they own;
(ii) examining the application of the various ATED reliefs; and
(iii) arranging for the submission of the return.

However, in many cases, companies have found that there is an additional complication.

A typical property-owning structure consists of a company (or a company owned by a trust) holding a residential property and no further assets. With no cash in the structure, it has been necessary to consider how the company will fund the payment of its ATED liability.

Other than external borrowing, there are three principal methods of financing the tax payment in the absence of a cash asset. Each of these will have tax implications, depending on the particular circumstances of the company. They are:

(i) the individual occupying the property pays the tax or makes a gift to the company;
(ii) the individual occupying the property makes a loan to the company; or
(iii) the individual occupying the property subscribes for additional shares in the company.

A possible pitfall with the approach in (c)(i) above is that, where a trust is involved, this will be treated as a transfer to a settlement and could therefore attract 20% IHT on a chargeable lifetime transfer. If the structure does not include a trust, a gift to the company will not be reflected in the base cost of the shares on a future sale or liquidation, thereby increasing a prospective CGT charge.

The main difficulty with (c)(ii) above is that a subsequent repayment of the loan could trigger the anti-avoidance legislation in S633 ITTOIA 2005 which will result in a tax charge if, at any time, there has been income in the structure.

The trap with (c)(iii) above is that, if there is a trust in the structure, any funds introduced through the trust could result in an IHT charge. Alternatively, if the funds are paid directly into the company, this may impact on the ownership of that company and could disturb other IHT planning arrangements.

It is clear that there is no 'one size fits all' approach to funding a payment of ATED. Companies need to explore the alternative options, navigating any anti-avoidance legislation as best they can, in order to find a tax-efficient means of financing the payment.

Contributed by Robert Jamieson

Administration

Victory for HMRC in the Cotter case (Lecture P810 – 20.32 minutes)

Earlier this month, HMRC won an important ruling in the Supreme Court – the case in question was *Cotter v HMRC (2013)*. It is estimated that in the immediate future another 200 taxpayers will be affected by this decision, leading to an overall saving for the Government of what could be as much as £500,000,000. The key principle to emerge from the case is that taxpayers who allow HMRC to calculate their income tax and CGT liabilities must pay the resulting assessment in full, even if they subsequently submit a claim to reduce their assessment by carrying loss relief back from a later tax year.

The taxpayer (C) had filed a paper tax return for 2007/08 in October 2008 and had asked HMRC to calculate his tax liability for that year. No claim for loss relief was made in the return. When C's bill arrived from HMRC in December 2008, he was astonished to find that he owed tax of almost £212,000. C then consulted his accountants and, in January 2009, they informed HMRC that their client had sustained a loss of £710,000 in 2008/09 and that he wished to carry this loss back to 2007/08, as a result of which no further tax would be due for the earlier year. They requested that C's tax return be amended accordingly.

In due course, HMRC opened an enquiry into the loss claim under Sch 1A TMA 1970. This procedure relates to claims which have not been included in a tax return – these are often referred to as free-standing claims. As a result, HMRC refused to give C credit for his loss claim and demanded that he settle his original liability of £212,000 in full. Backed by his accountants, C challenged HMRC's intransigent position. The argument of C's advisers was that the tax bill of £212,000 was not due and payable unless and until HMRC:

(i) had completed their enquiry; and
(ii) had decided to reject the loss relief claim (with, if necessary, that decision being supported by the First-Tier Tribunal).

HMRC disagreed with this stance and launched County Court debt recovery proceedings against C.

The resulting case was then transferred to the High Court which found for HMRC. C appealed and, in February 2012, the Court of Appeal reversed this ruling. HMRC in turn petitioned the Supreme Court which issued judgment under Lord Hodge (with whom the other four Law Lords were in agreement). As indicated in the title of this chapter, they supported HMRC's position.

The central plank of C's pleading was that HMRC's use of Sch 1A TMA 1970 was incorrect and that any investigation into his tax return should have been carried out under S9A TMA 1970, given that the loss claim, following the accountants' amendment in 2009, had been included in the return. The relevance of this point was summarised by one commentator as follows:

'An enquiry under S9A TMA 1970 does not disturb the taxpayer's self-assessment until either the enquiry is concluded or an amendment is made by HMRC under S9ZB TMA 1970. By contrast, a free-standing claim that is enquired into does not take effect until the enquiry is completed, unless provisional relief is given by HMRC.'

In other words, the correct construction of the relevant course of action depends on the answers to two questions:

(i) Was the claim in C's amended 2007/08 tax return a claim which affected the calculation of his tax for 2007/08 in view of the fact that it dealt with a loss incurred in 2008/09 but related back to 2007/08?

(ii) For the purposes of S9A TMA 1970, was the claim 'contained' in C's tax return for 2007/08?

The answer to the first question can be found by examining Sch 1B TMA 1970 which deals with claims for relief involving two (or more) tax years. In this situation, claims are given in the later year by reference to a calculation of what the tax saving would have been in the earlier year had the loss claim in this case been taken into account. That is to say, it is necessary to establish the value of the tax relief in 2007/08 which is then given as a deduction in the 2008/09 assessment.

C's tax liability of £212,000 for 2007/08 could not therefore be overturned by his loss claim for 2008/09.

This leaves the other question to be decided. Was the loss claim 'contained' in C's 2007/08 tax return? Here HMRC's argument was outlined by Lord Hodge when he said that a claim was included in a return for enquiry purposes 'only if it affected, or . . . could "feed into", the calculation of tax payable in respect of the particular (tax year)'. Despite the correspondence from C's accountants asking HMRC to amend his 2007/08 tax return when the loss claim was submitted (which could have brought the enquiry within S9A TMA 1970), Lord Hodge appears to have been persuaded by HMRC's barrister that to do so would expose HMRC 'to irrelevant claims made in the tax return form which have no merit and which serve only to postpone the payment of tax which is payable'. He goes on to assert that, if he had followed the Court of Appeal's line, this might 'encourage marketed tax avoidance schemes which would give a cash flow advantage to taxpayers, even if the schemes were ultimately found to be ineffective'. This is because, as was set out in (e) above, an enquiry under S9A TMA 1970 allows the taxpayer's self-assessment to stand until the enquiry is completed, whereas an enquiry started under Sch 1A TMA 1970 maintains the taxpayer's original status quo (ie. any amendment is *not* taken into account until the conclusion of the enquiry). Lord Hodge determined that the claim was not 'contained' in C's 2007/08 tax return and so HMRC were entitled to use Sch 1A TMA 1970.

Where all this seems to be leading is that, if C had calculated his own liability, this would have meant, as one commentator has argued, 'that the claim was made within the tax return and any enquiry would have had to have been started under S9A TMA 1970'. The same commentator goes on to remark:

'This appears to be because the reduction in tax is now established as part of the self-assessment, but (Lord Hodge) himself recognises that this completely undermines the argument that unwarranted claims

under tax avoidance schemes can postpone the need to pay tax. If the taxpayer completes the tax calculation rather than allowing HMRC to do so, a Sch 1A TMA 1970 enquiry is impossible.

The other result of this distinction is that there is a rigid demarcation concerning the correct way to start an enquiry in “two-year” cases such as this. If the taxpayer completes the tax calculation, then the enquiry *must* be started under S9A TMA 1970, but, if he does not, it *must* be started under Sch 1A TMA 1970. It is understood that HMRC have not always been so particular about the section used and, in any case, no-one appreciated the distinction between cases where the taxpayer had or had not completed the tax calculation until this previously undiscovered tectonic faultline was illuminated by Lord Hodge. There are, apparently, many taxpayers who have had enquiries opened under the “wrong” section. Are the conclusions of these now null and void and can they ask for their tax back?’

The inference from all of this is that TMA 1970 – at nearly 44 years of age – is well overdue for a major rewrite.

Contributed by Robert Jamieson

Disclosure justified

During a meeting between the then HMRC permanent secretary for tax, Dave Hartnett, and two journalists from The Times, Mr Hartnett alleged that IMH, an investment and media group that promoted film investment schemes in the form of partnerships, was marketing tax avoidance schemes.

The newspaper subsequently published articles which referred to Mr Hartnett's allegations about IMH.

The founder of IMH sought a judicial review, claiming declaratory relief that the disclosures made by Mr Hartnett were unlawful. He said that in making them, HMRC had breached Revenue and Customs Act 2005, s 18 (confidentiality), their own guidance, and IMH's rights under article 8 of the European Convention on Human Rights.

Decision:

The Queen's Bench Division said there was a “rational connection” between HMRC's role in collecting tax and the comments made by Mr Hartnett during the meeting with the journalists. His judgment in deciding to disclose the information about IMH fell within s 18.

Furthermore, Mr Hartnett had not deliberately targeted the claimants. The judge said: “Mention of the claimants arose naturally in the context of the questions which the journalists asked regarding tax avoidance, with particular reference to film investment schemes.” Had personal tax details of a taxpayer been revealed, this would have been different.

The judge concluded that HMRC had not breached the law, their own guidance or the human rights convention.

The claimants' application for judicial review was dismissed.

Comments – The right of confidentiality is an important aspect of a taxpayer's affairs with HMRC. This does not represent a normal case as in nearly all situations HMRC is scrupulous about the confidentiality of a taxpayer's affairs.

R (on the application of Ingenious Media Holdings plc and another) v CRC, Queen's Bench Division, 25 October 2013

Accountant failed client

After Ms M's husband was killed in a car accident, his business was closed for six months until 2011. In January 2012, bailiffs arrived at the premises to collect unpaid penalties in respect of late P35 returns for the years 2008/09 and 2009/10. Ms M did not know anything about these, so turned to the business's accountant for explanation.

The accountant acknowledged that the returns had not been filed but delayed further in dealing with the situation. Eventually the returns were filed and Ms M decided to appoint a new accountant.

Decision:

The First-tier Tribunal accepted that Ms M had little time to attend to her late husband's business. There was no reason to suppose that the penalty notices had not been sent on to the accountant by the husband before he died, but the judge concluded that the husband would have assumed the company's tax affairs were in order on the basis that this was what the accountant told him.

However, despite it being the responsibility of the taxpayer to ensure that his tax obligations are dealt with, if he is relying on an agent who turns out to be dishonest and unreliable, the taxpayer may have reasonable excuse when his affairs fall behind. In this instance, the tribunal decided this was the case.

The taxpayer's appeal was allowed.

Comments – Although reliance on an agent will not generally be regarded as a reasonable excuse there are occasions when it will be extenuating circumstances. In light of the facts the Tribunal exercised their judgement and determined that this was one of those circumstances. When an accountant proves to be dishonest and unreliable it is not surprising that the Tribunal found in favour of the taxpayer.

Yellow Crown Ltd TC2915

Reasonable excuse: reliance on accountant

An accountant — who purported to be a member of ICAEW — had been appointed by a company director to manage the company's tax affairs. This included the filing of tax returns and the setting up of a PAYE scheme (the 'scheme'). The accountant was actually not a member of ICAEW and never contacted HMRC to set up the scheme.

When a paper return had been rejected by HMRC (as it should have been filed online), the director had become aware of a problem and had appointed other accountants, who proceeded to bring their client's affairs into order expediently. The issue was whether the reliance by the company director on an accountant was a reasonable excuse.

Decision:

The tribunal found in favour of the taxpayer, who 'had had no reason to suspect' that the first appointed adviser was not truthful and had remedied the situation as soon as she had become aware of it.

Comments - HMRC had refused to consider the FTT's decision in Stephen Rich [2011] UKFTT 533 (TC) — which turned on a similar point — arguing that it was not a precedent. The tribunal stressed that the FTT's decisions do provide 'informed guidance' and that Stephen Rich was relevant. HMRC should therefore be referred to both this case and Stephen Rich in circumstances involving reliance on a third party.

Providence Health Consultants Ltd v HMRC (TC02988

Self-assessment late filing penalty

Mr Porter traded as a surveyor. His wife dealt with his bookkeeping and PAYE matters. HMRC printouts confirmed that, two months before the filing deadline, she had logged on to the department's website to file the form P35 for 2010/11. She had also confirmed by phone that the information had been received by HMRC. Unfortunately, it seemed that she had failed to press a button or tick a box, such that the actual submission had not been made. As a result, four £100 penalty notices were issued, plus another £100 for the following month.

The taxpayer appealed contending that there was reasonable excuse for the failure to file and that the delay in notification by HMRC was unacceptable.

Decision:

The tribunal had no hesitation in finding that numerous efforts had been made to file the return and that Mrs Porter had misleadingly been told that this had been successful. The penalty should not have been imposed and was to be repaid.

Comments – This is another case which demonstrates the importance of the clarity of operation of computer systems. A taxpayer must be able to rely on the computer system correctly informing in regard to the filing or other actions taken by a taxpayer. This case is another that demonstrates that where the taxpayer can demonstrate with evidence the efforts undertaken the Tribunal will often look favourably on the taxpayer.

DJ Porter v HMRC TC2907)

Notice must be specific

The appeals of two taxpayers were joined, although they had been scheduled to be dealt with individually, because they both concerned the daily penalty regime introduced in FA 2009, Sch 55 for late self-assessment tax returns.

The first taxpayer, M, posted his 2010/11 tax return on 27 April 2012, after contacting HMRC on 14 March. HMRC imposed a £100 late filing penalty (Sch 55 para 3), which he paid, because he knew that a return was due for that year. They also charged daily penalties under Sch 55 para 4, against which M appealed. He said that, had he been told on 14 March that daily penalties were accruing, he would have filed his return online immediately.

The second taxpayer, D, filed his 2010/11 tax return on paper on 1 May 2012, in response to a letter from HMRC dated 18 April warning him about daily penalties. He was charged a £100 penalty under Sch 55 para 3, daily penalties of £900 under para 4, and £300 six months late penalty under para 5. D appealed against all the penalties.

Decision:

The First-tier Tribunal decided that HMRC had not given proper notice of the daily penalties, as required by para 4(1)(c). The SA326D notice which they had used was not appropriate because it did not specify a date from when penalties would apply and it did not tell the taxpayer that penalties would be charged, rather that they could be.

The taxpayers' appeals against daily penalties were allowed. D appeal against the £100 and £300 late filing penalties was dismissed because no special circumstances applied.

Comments – Where penalties are imposed it is essential that proper notice is given by the taxing authorities. Both these cases demonstrated failures in that process and therefore the Tribunal found against HMRC. It should always be remembered that there are procedures that HMRC is obliged toi go through and where those procedures are not followed then there is an avenue to explore.

R Morgan; K Donaldson TC2720

Reasonable misunderstanding

The taxpayer and his wife were pensioners who ran a rural plant nursery. They appealed against a penalty for the late filing of their 2010/11 employer end-of-year return. They employed one person for two four-month periods during the year. They were not computer literate but had managed to submit the employer end-of-year return electronically by the deadline for some years. They usually received a CD-ROM containing the HMRC software for filing the return, but did not receive one in 2010/11. They had to download the software instead, which was difficult due to the slow internet speeds where they lived. They submitted the return on 27 April 2011 and received a confirmation email from HMRC.

HMRC said the taxpayer had made a test submission and that the confirmation email would have made this clear, but produced no evidence.

Decision:

The First-tier Tribunal said it was “not prepared for purposes of this appeal to make a finding that the appellant would have received a message on the computer screen indicating whether the submission was a test transmission or a live submission”. If HMRC wished to rely on how the system worked, it should have provided evidence.

The taxpayer and his wife had taken steps to meet their responsibilities and approached the task of filing the employer return with diligence. They had to struggle with a new way of loading the software for 2010/11 and had spent some time speaking to the HMRC helpline. Under the circumstances, the tribunal was “persuaded that the experience as a whole could have left a reasonable and diligent taxpayer sufficiently distracted that, despite good faith efforts, the return was inadvertently sent as a test transmission”. Once the taxpayer realised what had happened, he tried contacting the Revenue on a couple of occasions and finally filed the return in January 2012.

The taxpayer had reasonable excuse for the late submission. His appeal was allowed.

Comments - The taxpayer and his wife had taken steps to meet their responsibilities and approached the task of filing the employer return with diligence. If HMRC wished to rely on how the system worked, it should have provided evidence. These are self sufficient.

Gordon West, trading as Dishforth Nursery Gardens TC2868

Reasonable excuse: HMRC's IT failure

A company was appealing against a penalty imposed by HMRC for the late filing of an employer annual return. The only employee of the company had written to HMRC on 15 May 2012 (before the deadline for online submission), enclosing a hard copy of the return and explaining that he had encountered technical difficulties when attempting to submit the return online. The letter also pointed out that the information required by HMRC was saved on its website. HMRC explained in a letter dated 9 July 2012 that it was unable to resolve the issue and that the taxpayer should contact the online helpdesk. The company had then contacted HMRC on several occasions without being able to resolve the problem. HMRC had issued penalty notices on 24 September 2012 and then on 27 May 2013.

Decision:

The tribunal found (referring to the attempts made by the company to resolve the problem) that 'these were the actions of a reasonable taxpayer faced with a difficulty he could not overcome'. The taxpayer had therefore established a reasonable excuse up to the end of 2012. However, his failure to make contact with HMRC at the beginning of 2013 — when he knew that the problem remained unresolved — showed 'a lack of persistence'.

Comments - As most filing requirements are now met online, it is reassuring that an IT failure (on HMRC's side) can constitute a reasonable excuse.

Smart Polymers Ltd v HMRC TC2987

LPP and engagement letters

The taxpayer was appealing against an information notice issued by HMRC under FA 2008 Sch 36 para 1, on the ground that the information requested was protected by legal professional privilege (LPP). HMRC had requested copies of both the taxpayer's engagement letter with his solicitors and of a report on trust arrangements prepared by them. HMRC referred to Dickenson v Rushmer [2002] 1 Costs LR 128 as authority for the proposition that an engagement letter is not subject to LPP.

Decision:

The tribunal agreed but only in so far as the letter 'sets out the terms of the contract' between the solicitor and his client. If this was the case, it could not attract LPP, as the lawyer was not giving advice 'qua lawyer'. The position was however different if the engagement letter also specified the matter on which legal advice was required. The tribunal explained that LPP extends not only to the content of legal advice but also to the fact that legal advice is sought on a particular matter. The tribunal concluded that certain parts of the engagement letter were therefore privileged and that the entirety of the report on trust arrangements was privileged. The tribunal also found that the appendix to the report — which contained mainly legislation — was privileged, as it would enable a reader to identify the subject of the report.

Comments - Although LPP is often argued, the case law on LPP is rather limited and so this case brings some welcome clarification to the application of LPP.

Edward C Behague v HMRC TC2983

Discovery Assessments – No Protection? **(Lecture P809 – 13.39 minutes)**

The legislation – Section 29 TMA 1970

Following the discovery by HMRC of an insufficiency within a return, the taxpayer shall not be assessed after such time as the enquiry window has closed unless one of the two conditions mentioned below is fulfilled:

1. The first condition is that the insufficiency in the return was brought about carelessly or deliberately by the taxpayer or a person acting on his behalf.

2. The second condition is that at the time when an officer of the Board ceased to be entitled to give notice of his intention to enquire into the taxpayer's return in respect of the relevant year of assessment; or informed the taxpayer that he had completed his enquiries into that return, the officer ***could not have been reasonably expected***, on the basis of the information made available to him before that time, ***to be aware of the insufficiency.***

It should be noted that a mere suspicion that there may be an insufficiency to tax is not adequate grounds for raising a discovery assessment.

In terms of how far back HMRC are entitled to look, this is governed by the behaviour associated with the insufficiency. Where the taxpayer has been careless, the 'normal' assessing time limits of 4 years are extended to 6 years. In cases of deliberate behaviour this is extended further to 20 years. The onus is on HMRC to prove that the taxpayer has demonstrated careless or deliberate behaviour.

Information made available

This will include the following:

a. contained in a relevant return or any accounts, statements or documents accompanying a relevant return (or claim)
b. contained in any documents, accounts or particulars supplied in connection with an enquiry into any relevant returns or claims
c. information whose existence could be reasonably expected to be inferred from information available as above or information notified in writing to HMRC by the taxpayer.

HMRC approach to discovery

- HMRC raise the discovery assessment and allow the case to proceed to Tribunal.
- The taxpayer is effectively trapped once the assessment is in place, the only way to tackle HMRC is by way of an appeal.
- In recent cases it is evident that the Tribunal has chosen to consider the merits of the assessment before the validity.
- The Tribunal is potentially swayed by amounts or the principles at stake.
- The interconnection of behavioural categories to both time limits and penalties provide HMRC with a double incentive to argue careless/deliberate.
- Increasingly, HMRC appear to be using the discovery provisions as a fall-back position when an item is missed during the period in which the enquiry window remains open.

Recent cases

William Blumenthal [2012] UKFTT 497 (TC)

Tribunal decided that the inclusion of the capital loss on the tax return was sufficient to alert the inspector to make further enquiries, but not so as to make him aware of an actual insufficiency. It was decided that where complex issues are concerned, the disclosure should include a brief explanation of the tax issues involved and the position taken by the taxpayer.

Michael Freeman [2013] UKFTT 496 (TC)

The ruling in this case stated that information supplied during the course of a previous enquiry should have been considered by the inspector and would have allowed him to be made aware of the insufficiency. The case considers the concept of a competent officer and his ability to infer from the information included within the return that additional information existed which would be relevant to the case.

Robert Smith (TC 2768)

The appeal in this case was dismissed on the basis that HMRC had a change of opinion in relation to the treatment of SHIPS (second hand insurance premiums scheme). The enquiry was not opened as the inspector was on sick leave but the Tribunal decided that HMRC were able to raise a discovery assessment in order to correct a previous oversight.

Advice to clients

The recent cases have highlighted the importance of including a comprehensive disclosure within the return 'white space'. A quality disclosure included within the return and the accompanying documents should provide a robust defence against discovery but there remains very little guarantee of finality over a client's tax affairs.

Contributed by Isobel Clift, Gabelle LLP

Business Taxation

Payment to preserve trade

The taxpayer was a partner in the law firm, Haarmann Hemmelrath until the end of 2005 when the London office was acquired by Squire Sanders & Dempsey and he became a partner in that firm.

In October 2009 he claimed a deduction, under ITTOIA 2005, s 34, of £215,455 against his professional income from Squire Sanders & Dempsey. The deduction related to a payment he had made to a German bank (BL). This was under an agreement made by a number of individuals who had been connected with Haarmann Hemmelrath. When that firm ceased to trade it left debts of some €17m to several banks.

BL decided to sue the UK partners of Haarmann for payment. Rather than going through the German courts, risk losing and as a result becoming bankrupt, the taxpayer made an agreement to pay €300,000 to BL to release him from all claims to the bank. He made the payment in January 2008.

The taxpayer agreed that the payment had enabled him to avoid bankruptcy and protect his reputation, but he said his purpose in making it was to protect his professional career. He claimed it was a revenue payment made wholly and exclusively for the purposes of his profession.

HMRC rejected the claim. They said the taxpayer did not carry on a profession as an individual and that the payment was a capital expense.

Decision:

The First-tier Tribunal accepted the taxpayer's argument that it is “the partners who are treated as carrying out the trade and not the firm itself ”. He referred to s 863 which states that this is the position with regards to limited liability partnerships, concluding that each partner is carrying on a trade, even if it is collectively with others, and therefore his profits are taxed on him individually.

The taxpayer cited McKnight v Sheppard [1999] STC 669 to support his contention that the payment he made to the bank was to preserve his professional career. The tribunal accepted his argument and found that the payment was wholly and exclusively for the purposes of his trade. Agreeing with the taxpayer's submission that “no asset or enduring advantage was brought into existence by the payment” to BL, it followed that the payment was a revenue and not a capital one.

The taxpayer's appeal was allowed.

Comments – This is the latest in a number of cases dealing with a sum of money being paid to protect the trade. In this instance the taxpayer was both a barrister and Chartered Accountant and therefore would have a much better understanding of the principles than many taxpayers. The arguments advanced for the taxpayer were based on previous decisions and therefore gave a positive result. This will be a useful case in support of future arguments on the nature of such expenditure.

P Vaines v HMRC TC2965

Righting wrongs

The taxpayer's business provided services to taxi drivers who had been involved in “no fault” car crashes. The dispute centred on the treatment of receipts for the hire of cars to the drivers while their own vehicle was off the road. The taxpayer's practice was to produce a rental contract for the replacement car, but the charge to be levied for this was left blank until the insurance company of the other driver admitted liability. Once that happened, figures were entered and a claim was made. The insurance companies often refused to pay the full amount claimed and commonly a lower or much lower figure would be agreed.

The taxpayer's accounts had been prepared on a cash basis in this regards.

HMRC contended that, to comply with UK generally accepted accounting practice, accounts should be on an accruals basis and an amended assessment was issued for 2004/05 — the first year of the business — increasing the assessable income by approximately £75,000.

One year later, the taxpayer's accountant contended that an appeal had been lodged. HMRC could find no evidence of this and refused to accept a late appeal.

Decision:

On appeal, the tribunal decided to accept a late appeal. They did not do this lightly, but pointed out that refusal to allow this would mean that the taxpayer would pay tax on an additional £75,000 of income because accounts for the following years had continued to be prepared on a cash basis, despite HMRC's assertions to the contrary. The tribunal wondered whether, if the taxpayer's assertions that a cash basis should be used proved to be wrong, whether any adjustments might be made for the later periods which were not out of time for an appeal. The judge felt that a negotiated settlement without having to proceed to the tribunal would be the ideal outcome.

Comments – The Tribunal had to consider this case carefully in light of the principles involved. It is of course ironic that the cash basis has been introduced into law by FA2013. However the Tribunal has exercised fair judgement – even though HMRC could find no evidence of the appeal the Tribunal allowed it – the negotiated appeal would be the best outcome.

S Mahmood t/a Elite Claims (TC2906)

Capital allowances on property – apportionments **(Lecture B806 – 16.31 minutes)**

Section 562 of the Capital Allowances Act 2001

Capital allowances statute (CAA 2001, s 562) contains a general rule that applies to all capital allowances. This includes plant and machinery and all classes of property (that is, chattels and fixtures).

This says that all property sold as one bargain is treated as being sold together, even if separate prices are agreed (or purport to be agreed) for separate components of that property.

If an item of property is sold with other property, then for capital allowances purposes, the price paid should be attributed to that item on the basis of a "just and reasonable apportionment" of the total paid for all of the property.

For example, where land and buildings/ premises (which do not qualify for plant and machinery allowances) are sold with plant and machinery fixtures (which do qualify for allowances).

The underlying aim of an apportionment is to apportion the expenditure in proportion to the values of the constituent parts that go to make up the property (*Salts v Battersby* [1910] 2 KB 155).

Valuation Office Agency endorsed formula approach

There is a well-established standard methodology for preparing capital allowances apportionments. This is published and endorsed by the Valuation Office Agency (VOA), which is an Executive Agency of HMRC. It is referred to as the formula approach. Whilst it is not stipulated by statute (and, therefore, not mandatory) it is used in the vast majority of normal circumstances. A business would need strong reasons to depart from it.

The formula approach uses the following fraction to establish the *proportion* of the total sale and purchase price which is attributable to the plant and machinery that qualifies for capital allowances:

$$P \times \frac{A}{A + B + C}$$

P = Purchase price

A = The replacement cost of qualifying items of plant and machinery

B = The replacement cost of the whole building excluding qualifying items of plant and machinery

C = The bare site value

The replacement cost of the building and plant and machinery is the hypothetical estimated cost of replacement if work had started at the appropriate time to have the building available for occupation at the date of purchase.

The bare site value is the hypothetical open market value of the actual site at the date of purchase assuming that the site is cleared, planning permission is available for the right type of development, and access and services are available up to the boundary.

Example

A business buys a freehold property for £1,500,000. A specialist capital allowances valuation is prepared. This establishes that the replacement cost of qualifying items of plant and machinery is £375,000; the replacement cost of the whole building (excluding qualifying items of plant and machinery) is £600,000 and the bare site value is £325,000:

$$£1,500,000 \times \frac{£375,000}{£375,000 + £600,000 + £325,000}$$

$$£1,500,000 \times \frac{£375,000}{£1,300,000}$$

$$£1,500,000 \times 28.85\% = \mathbf{£432,692}$$

The formula attributes around 29% of the £1,500,000 total purchase price to plant and machinery (that is, is £432,692).

The 'multiplier'

The actual purchase price of £1,500,000 is about 15% higher than the hypothetical formula denominator of £1,300,000.

This extra £200,000, in effect, reflects the market value premium for the property, or value created by the developer by combining the land and building. The effect of the formula is to apportion that premium/ developer's profit between the elements that comprise the property.

In this example there is a positive 'multiplier' (that uplifts the hypothetical replacement cost of the plant). This is normal in a buoyant property market. Conversely, if the purchase price is less than the denominator, then there is a negative multiplier which depresses the apportionment to plant. That happens in challenging economic conditions, or, for example, where the bare site value or replacement cost of the building is disproportionately high (such as it being a large valuable site, or a listed building for which the cost of erecting an identical modern substitute would be abnormally high).

Underlying assumptions

The law of real property contains a general rule that anything attached to the soil becomes part of it. So, the land, building, and plant and machinery fixtures are one asset (the soil) which goes up and down in value (as one) with the property market cycle. Because it is regarded as a single asset it would not be normal to adjust the values of the constituent parts (that is, the land, the building and the plant and machinery) so that they are dealt with independently of each other.

Furthermore, even though the building and plant and machinery may well be showing signs of age, the replacement costs used in the formula are not written-down. This is because any obsolescence is normally already reflected in the purchase price (a new or well-maintained building ought to cost more to buy than one nearer the end of its life). Then, through the application of the formula, this is reflected in the apportioned values of the elements of the property. An effect of the formula is to write up (or down) the values of *all* those elements, including the land. Although land does not fall in value with age it will in most cases be encumbered by an ageing building, so the full land value is not actually realisable because it would not be economic to demolish the building until it has reached the end of its life.

Interaction with Capital Allowances Act 2001 section 185

After preparing a CAA 2001 s 562 apportionment, then for any plant and machinery upon which the seller has claimed allowances, a buyer will need to apply the restriction set out in CAA 2001 s 185. This limits the buyer's claim to the seller's (or a previous owner's) disposal value. In a property market which has risen this would commonly be limited by CAA 2001 s 62 to the qualifying expenditure originally incurred by the seller (or previous owner) on that particular fixture.

A buyer's claim can comprise a combination of approaches. For fixtures which have not been claimed on previously, then the buyer's claim is calculated using an apportionment (as described above). But for other fixtures where a claim has been made previously then the buyer's claim will be limited to the seller's disposal value (that is, generally the seller's qualifying expenditure). This would over-ride the apportionment for that item. But if an apportionment is needed to value any individual fixture then it is essential that the formula must include *all* of the assets. This is because the formula establishes an appropriate proportion of the *total* which is attributable to the item (or items) that the taxpayer is interested in. Therefore, everything has to be included in the denominator. To do otherwise, would hopelessly compromise the integrity of the formula.

Contributed by Steven Bone

Loan relationships: accounting treatment & unallowable purpose

Groups of companies had entered into a scheme designed to achieve a corporation tax deduction for interest paid on intra group debt in one group company, without the corresponding taxable income for the lending company. The 'lender' had made a loan to the 'borrower'. The principal had been repayable to the lender; however, the payment of interest was by an issue of irredeemable preference shares by the borrower to a 100% subsidiary of the lender; the 'share recipient'.

Decision:

First, the tribunal found that the accounting treatment adopted by the lender — which did not recognise a profit from the loan — was compliant with FRS 5. The transaction had not created a new asset for the lender — which had granted a valueless interest free loan. Second, ICTA 1988 s 786 did not apply. The lender had not forgone income on a transaction 'with reference to the lending of money'. The transaction was not 'with reference' to a loan; it was a loan on which no right to interest had ever existed for the lender, who could therefore not have foregone it. Third, the shares received by the share recipient constituted taxable income with a source. The borrower had issued the shares in compliance with its obligations under the loan agreement, which was therefore the source of the income received by the share recipient. Finally, the mere fact that the borrower knew that the transaction would deliver a tax advantage did not mean that the tax advantage was the main purpose of the transaction and so the transaction did not have an 'unallowable purpose' (FA 1996 Sch 9 para 13) and the interest was therefore deductible. The appeals of the lender and borrower were allowed; however, the appeal of the share recipient was dismissed.

Comments - The scheme had been implemented by many groups and so its overall failure will be a disappointment. That said, the analysis of the purpose of the borrower is helpful in suggesting that it may be possible to structure a transaction so as to achieve a tax advantage without falling foul of anti-avoidance provisions which refer to the 'main purpose' of a transaction.

Versteegh Ltd and Others v HMRC TC/2012/5569

Activities carried on otherwise than for profit

The Professional Golfers' Association (PGA) was appealing against HMRC's decision to deny approval under ITEPA 2003 s 344. The benefit of approval was that its members would be entitled to deduct their annual membership fees when computing their taxable earnings. In order to fall within the ambit of s 344, the PGA had to show (inter alia) that its activities were carried on 'otherwise than for profit' and that its activities were 'wholly or mainly directed' at objects listed in the section (broadly: the dissemination of knowledge, the maintenance of standards and the provision of indemnity).

Decision:

The tribunal saw no difficulty with the fact that the PGA carried out commercial activities for the purpose of generating income which was 'ploughed back' into activities for the benefit of its members. The fact that the benefit may be an increase in the income of its members did not change the analysis — the profit which might offend s 344 is the profit of the association. However, the PGA failed on the second test at issue, as the activity of organising tournaments — which represented 56% of its expenditure — had the main purpose of assisting members in developing their earning potential. The purpose which would have fitted the permitted objects, namely the maintenance of professional standards, was only ancillary. The appeal was therefore dismissed.

Comments - The phrase 'otherwise than for profit' appears in a few places in the tax legislation (for instance, in the context of the VAT exemption for charities). The pragmatic approach adopted by the tribunal in favour of the association may be a useful reference, even though the appeal was dismissed on a separate ground.

The Professional Golfers' Association v HMRC TC2992

Amortisation of intangible assets

Armajaro (AHL), a company, had set up a limited liability partnership (AAM) with individual members. AHL had subsequently purchased the partnership interests of three members. The issue was whether intangibles relief was available under FA 2002 Sch 29 in respect of the acquisitions. This would only be the case if either AAM was tax transparent (and therefore AHL had a direct interest in the goodwill of AAM), or AHL's interest qualified as 'an interest in partnership property that is an intangible asset'.

Decision:

The First-tier Tribunal found that ICTA 1988 s 118ZA(1) only deemed an LLP to be transparent for corporation tax purposes and so AAM was not transparent for Sch 29 purposes. On the second point, the tribunal relied on expert evidence provided by a chartered accountant which suggested that, as AAM was an LLP, it was a distinct legal person and so its assets were not assets of its members. The tribunal added that although if AHL had been a general partnership, it would have been able to consolidate the goodwill of AAM in its accounts, this fact was of no assistance to AHL.

Comments - The intangible asset regime is now contained in CTA 2009 Part 8. Its main benefit is that it allows the amortisation of intangible assets for tax purposes by way of allowable deductions. The case suggests that these assets should be held in general partnerships and not in LLPs, in order to benefit fully from the regime.

Armajaro Holdings Ltd v HMRC TC2960

Payments to employee benefit trusts

A company entered into a tax avoidance scheme, devised by an accountancy firm and described as a 'discounted options scheme', with the aim of providing additional remuneration to seven of its employees without incurring liability to PAYE or NIC. The scheme involved payments into an employee benefit trust, which acquired 15 Isle of Man companies, and which purported to settle nominal sums on family benefit trusts for the relevant employees and to grant each of the family benefit trusts share options in one of the Isle of Man companies. The intention of the scheme was that there would be no UK tax charge on the cash held in the Isle of Man company, until the cash was brought back to the UK (for example, by dividend or liquidation). HMRC issued determinations under Income Tax (PAYE) Regulations, SI 2003/2682, reg 80. The company appealed, contending first that the arrangements did not amount to a payment of income to the employees; and alternatively that if there were any tax liability, it should be recovered from the employees rather than the company.

Decision:

The CS unanimously rejected these contentions and dismissed the company's appeal. Lord Gill held that 'our concern is with the reality rather than with any simulation of reality that may be achieved by the interposition of a company, the issue of shares and the oversight of compliant directors'. On the evidence, it was 'obvious that the employee had complete control of the company and had immediate access to its cash.

The money box company was simply a conduit between the EBT and the employee. The directors' purpose was that of compliance with the objective of the scheme.' Applying the principles laid down in WT Ramsay Ltd v CIR, the transfer of shares to the employee was a 'payment'.

Comments - The CS unanimously upheld HMRC's contentions that the avoidance scheme was ineffective and that the company was required to account for PAYE and NIC. Commenting on the decision, Jim Harra, director general, business tax, HMRC, said: 'This decision will be a big help when we come to argue other cases that are currently in the courts. We hope this success will encourage more companies to cut their losses and come forward to settle their EBT liabilities on the basis that this kind of avoidance scheme does not work.'

Aberdeen Asset Management PLC v HMRC (CS)

Group relief provisions: whether valid under EC law

Several members of a group of companies (with an ultimate Hong Kong parent) claimed group relief in respect of losses made by a UK company (HUK) through an intermediate holding company (HS) which was resident in Luxembourg. HMRC rejected the claim on the basis that the effect of ICTA 1988 s 402(3B) and s 406(2) was that the companies were not entitled to relief. The companies appealed, contending that the relevant UK provisions contravened EC law. The First-tier Tribunal directed that the case should be referred to the CJEU for a ruling on whether articles 49 and 54 of the TFEU should be treated as precluding 'the requirement that the “link company” be either resident in the UK or carrying on a trade in the UK through a permanent establishment situated there'.

Decision:

Advocate general Jaaskinen expressed the opinion that what are now articles 49 and 54 'preclude a requirement that, for the purposes of a consortium relief scheme, the link company be either resident in the member state concerned or carrying on a trade in that member state through a permanent establishment situated there. However, those articles do not prevent national legislation from requiring that the lowest common parent within the group of companies to which the link company and the companies receiving the losses for tax purposes belong be resident in one of the member states or in a country belonging to the European Economic Area, and that the connections between the link company and the companies receiving the losses for tax purposes consist solely of such companies.'

Comments - The advocate general expressed the opinion that the UK legislation contravened the TFEU. It seems likely that the CJEU will uphold this opinion. For a discussion of the implications of the case, see the comment 'Consortium relief' (Michael Anderson), Tax Journal, dated 24 February 2012.

Felixstowe Dock & Railway Co Ltd v HMRC (and related appeals) (Case C-80/12)

Taxation of dividends

A large insurance company, and two associated companies, took proceedings in the Ch D, contending that the UK rules on the taxation of dividends were in breach of what is now article 63 of the TFEU. At an initial hearing (reported at [2011] STC 214), Henderson J expressed the provisional view that the claims fell within the scope of TMA 1970 s 33, but directed that the proceedings should be adjourned pending the ECJ decision in Test Claimants in the FII Group Litigation v HMRC (No. 2) (Case C-35/11).

Decision:

Following the CJEU decision in that case, Henderson J held a further hearing and delivered a lengthy judgment. He held, inter alia, that 'the test claimants have failed on the facts to prove their entitlement to a tax credit for the underlying tax actually paid; this failure involves no breach by the UK of the principle of effectiveness; and there is therefore no reason either to disapply the requirement of proof, or to grant a tax credit at the nominal rate as a proxy'. However, the UK was required 'to grant a credit at the nominal rate of corporation tax paid by the distributing company, quite separately from the credit for underlying tax actually paid'. The legislation should 'be construed in such a way as to grant a limited credit for foreign-sourced portfolio dividends of the amount needed to secure compliance with EU law'. ACT set against corporation tax which had been held to be unlawful must be repaid. Where repayments were due, interest should be paid on a compound basis.

Comments - There is a great deal of money at stake in this case. Henderson J's judgment extends for 99 pages, and merits reading in full, in view of the variety and complexity of the issues involved.

Prudential Assurance Co Ltd v HMRC (Ch D)

VAT

Services or goods?

The taxpayer took over the lease of premises that had previously been used as a hairdressing salon to convert it into a café. She contracted with her husband's building company, L, to carry out the refurbishment. The café opened in June 2007 and was not initially registered for VAT.

In 2010, HMRC conducted an investigation into the café and ruled that it should have been registered for VAT from October 2008.

In her VAT return for the period from October 2008 to May 2011, the taxpayer claimed input tax on the invoice from L on the basis that it related to the supply of goods. Under the registration rules, a taxpayer can claim the input tax on supplies of goods for up to four years before registration, and on supplies of services for up to six months before registration. HMRC said the invoice related to supplies of services and disallowed the claim. The taxpayer appealed.

Decision:

The First-tier Tribunal decided that L had carried out the single project of converting and renovating the premises. This was a supply of services to provide a refurbished building with incidental installation works. It was not a supply of goods.

HMRC were correct to deny the claim for input VAT on the invoice, because it related to services that occurred more than six months before the registration date.

The taxpayer's appeal was dismissed in this respect but allowed in relation to input on petrol receipts.

Comments - Neil Warren, independent VAT consultant, said: “The taxpayer could have protected her right to input tax recovery by registering for VAT at an earlier date on a voluntary basis, so that the invoice dated 30 July 2007 was within the six-month time window for services. A taxpayer can choose any date to register on a voluntary basis, as long as it is within the four-year period before the application date.

“Alternatively, she could have purchased all of the goods from a builders' merchant and then used the services of a separate contractor for the installation works and service element. The independent purchasing would have secured partial recovery of input tax on most of the goods, such as the fridges and air conditioning unit. But neither option was possible because VAT was not properly considered at the planning stage of the business operation.”

Ann Khoshaba trading as Cinnamon Café (TC2864)

Odd anomaly

The taxpayer submitted its VAT return online for the period ended 30 September 2011 on 8 November, one day later than the deadline of 7 November. The relevant VAT was collected by HMRC by direct debit on 11 November, three days after the submission of the return and also one day late. HMRC issued a default surcharge, against which the taxpayer appealed.

The taxpayer explained that the return was submitted late because the company was waiting for a substantial cheque to clear its bank account.

Decision:

Although lack of funds is not accepted as a reasonable excuse for late payment of VAT, the First-tier Tribunal found an anomaly on HMRC's website. This stated that a direct debit payment will be collected “three working days after the due date for your return” rather than “three days after the receipt of the VAT return”. The tribunal concluded that HMRC could have collected the direct debit payment on 10 November because the return had been received on 8 November, and this would have avoided a late payment.

The taxpayer's appeal was allowed.

Comments - Neil Warren said: “This is a case where a statement on HMRC's website contradicted its policy in practice, allowing a successful appeal by the taxpayer.” He added that businesses should always submit their VAT returns on time, and then “negotiate time to pay with HMRC's business payment support service, rather than delay payment by submitting a late return”.

The Staircase Company (TC2867)

Sole trader or partnership?

The taxpayer opened a hairdressing salon in 1998. Five years' later, he opened a restaurant. His wife was co-owner of the restaurant because this was a condition of the liquor licence, but the freehold of the premises was in his name only. She worked in the restaurant but received no money for this. The restaurant closed in 2011 because it was not financially viable.

HMRC said that the taxpayer was a sole trader in the hair salon and restaurant businesses. The salon's turnover exceeded the VAT registration threshold from September 2001 and the taxpayer registered for VAT. HMRC said that sales from the restaurant should also be subject to VAT, despite the turnover not reaching the threshold, because it was one of the taxpayer's businesses.

The taxpayer appealed, saying that he and his wife ran the restaurant in partnership, and it was therefore a separate legal entity. As such, there was no VAT liability on sales.

Decision:

The First-tier Tribunal was satisfied that the restaurant licence and liquor licence were in the names of the taxpayer and his wife. The judge noted also that the wife worked in the restaurant. The fact that she was not paid for her labour indicated that she was not an employee, but that she and her husband considered themselves to be running the business together.

Factors in favour of the taxpayer being the sole proprietor of the business were that revenue from the restaurant were paid into the husband's account and that he alone declared income from the business on his tax returns. However, this did not rule out the taxpayer and his wife working in partnership.

After considering the evidence, the tribunal concluded that, on balance, the restaurant was run as a partnership.

The taxpayer's appeal was allowed.

Comments - Neil Warren, independent VAT consultant, said : “The taxpayer did well to convince the tribunal that there was a separate legal entity for the restaurant. There was evidence pointing both ways so the conclusion had to be reached based on the balance of probabilities. The fact that joint names were relevant to both the restaurant and liquor licences was considered to be more relevant than bank account information and self-assessment tax returns, which is somewhat strange. The tribunal allowed the appeal but made the comment that the balance of probability was 'only just' in favour of the taxpayer.”

G Christodoulou TC2819

Flat rate scheme override

Mr and Mrs Saggers owned Mark Saggers Media Limited and provided journalism and media services. The company registered for VAT in April 2005, estimating its turnover for the next 12 months at £120,000, and HMRC approved the use of the flat rate scheme (FRS). The lower threshold for the scheme was £150,000 and the upper was either £225,000 or £230,000 in the period under enquiry.

In May 2010, HMRC advised the company that it was no longer eligible to use the FRS because the value of supplies in the previous 12 months was £236,375 and thus above the upper limit.

In October 2010, Mrs Saggers explained to HMRC that a one-off piece of work had boosted income and she expected turnover to be £191,500 in the following year. HMRC agreed that the scheme could continue to be used. But, in August 2012 Mrs Saggers advised that the upper limit had again been breached in 2011/12. However, the profit level had fallen and income was expected to be less than £230,000 in the following year. Furthermore all work was now on a freelance basis with no guaranteed income.

HMRC replied saying that, because of the level of turnover, the company's use of the FRS would be treated as ending on 31 December 2010 and advised that the VAT liability should be recalculated on the standard method.

The company requested a review of the decision and noted that it had assumed that it was entitled to rely on HMRC's advice that it could continue to use the FRS until notified otherwise. HMRC refused the appeal and advised that, to reinstate a business in the FRS when the upper limit had been exceeded, they had to override the automatic withdrawal system. Consequently, the onus was on the taxpayer to check whether the limits had been complied with as mentioned in Notice 733, paragraph 12.2.

Decision:

The company's appeal to the tribunal was dismissed. Although the company had acted in good faith and had not tried to evade VAT, VATA 1984, s 84(4ZA) only allowed the tribunal to interfere with HMRC's decision if it was unreasonable and had failed to take account of all relevant facts and circumstances. Although the company could not have known that HMRC were no longer automatically monitoring turnover, VAT is a self-assessed tax and VAT Regulations SI 1995/2518, reg 55N(3) places a duty on the taxpayer to advise HMRC when the threshold is breached. HMRC had allowed the FRS to continue to be used for two years where the limit had been exceeded; it was not unreasonable for them to refuse use of the scheme for a third year.

Comments - VAT consultant, Neil Warren, said that "The concession that a business can remain in the scheme if future annual income is expected to be less than £191,500 is only intended to reflect situations where a genuine 'one off' sale arose in the previous year, a sale that will not be repeated, rather than contracts or orders being lost by a business that are likely to be replaced by new ones in the future with other customers."

Mark Saggers Media Ltd (TC2815)

Too late for group treatment

The taxpayer company owned a property which it let out with no VAT charged on the rent. An associated company, Perrie Ltd, carried out property management services for the taxpayer, for which it paid £106,000 in 2008/09. The taxpayer claimed the input VAT on the fee. HMRC refused the claim on the basis that it was attributable to exempt rental activities. They also assessed the company to VAT that had been deducted as input tax in the previous three years and deregistered the company because it was not making taxable supplies.

The taxpayer appealed.

Decision:

At the first hearing, the tribunal asked why a group election had not been made to cover the taxpayer and Perrie. This was done in March 2012, with a request that it be backdated to October 2006. HMRC

refused the request, saying that, as a matter of policy, they did not permit the backdating of group applications to a date more than 30 days before receipt of the application.

At the second appeal hearing, the tribunal ruled that the claims for input tax were not allowable because the VAT was in respect of exempt property supplies. The judge also agreed with HMRC's decision to deregister the taxpayer on the ground that it made only exempt supplies. He also accepted HMRC's reason for refusing the application for backdated VAT group treatment.

The taxpayer's appeal was dismissed.

Comments -Neil Warren, independent VAT consultant, said: “With a VAT group in place, the management charges would have avoided VAT as intra-group supplies, therefore avoiding an irrecoverable source of input tax for the recipient. This is another situation where early VAT planning would have avoided a future problem with HMRC. Group registration has many advantages for VAT purposes, although care in some cases is needed to ensure there is not a problem with anti-avoidance issues.”

Chelham Ltd (TC2812)

Construction services: applicability of zero-rating

The taxpayer had hired a contractor to build a two storey beach house against a hillside. The upper floor was substantially smaller than the lower floor and the part of the lower floor not covered by the upper floor was covered by a terrace, at the rear of which an outdoor swimming pool had been built. The issue was whether the pool was 'part of' or 'incorporated in' or 'integral to' the house. If it was, then under VATA 1994 Sch 8 Group 5 items 2 and 4, the services consisting in the building of the pool were zero-rated. It was accepted that if the pool had been built inside the house, the services relating to its construction would have been zero-rated and that if the pool had been built separately from the house, the construction services would have been standard rated. The difficulty was that, although the pool was an outdoor pool, it was built in the roof of the lower floor and shared a wall with it.

The tribunal stressed that the provision of services of construction of swimming facilities were not normally part of the construction of a dwelling and so could not have been contemplated by the legislator and concluded that 'a swimming pool that is part of the same structure as a dwelling but nevertheless not contained within it cannot be said to fall within the zero-rate', in the same way as a dwelling built above a shop is 'conjoined but separate'.

Comments - The tribunal chose to ignore physical evidence to focus on a purposive interpretation of the legislation. HMRC may rely on this case wherever the taxpayer's argument is based on a physical technicality, which does not sit well with the purpose of the VAT legislation.

Terry McCann v HMRC TC3017

Part-exchange or discount on the sale price?

The taxpayer supplied 'sophisticated' whiteboards to schools for cash consideration and the supply by the school of obsolete equipment. The issue was whether these were part-exchange transactions; if not, the allowance for the obsolete items were effectively discounts.

Decision:

The tribunal, agreeing with HMRC's guidance, noted that an allowance on the old equipment regardless of its identity or condition should be treated as a cash discount for VAT purposes. However, the tribunal concluded from the evidence that the price given for the buy-back items was influenced by the 'general nature of what was bought back' and so could not constitute a discount. Furthermore, as it was impossible to work out how much the trade-in items were subjectively worth to the appellant, the cash price put on the amount of the non-cash consideration must govern the value of the non-cash consideration for VAT purposes.

Comments - Many suppliers of consumer goods offer price reductions on the trade-in of goods by consumers. This case clarifies the circumstances in which such a price reduction will be treated as a discount for VAT purposes.

AV Concepts Ltd v HMRC TC3030

After-school clubs & the exemption for supply of welfare services

The taxpayer was a company supplying trained and qualified sports coaches to run after-school clubs in state schools. The welfare benefit for the children was obvious. The issue was whether this was sufficient to bring those services within the ambit of VATA 1994 Sch 9 Group 7 item 9 as welfare services supplied by a 'state regulated private welfare institution' — so that they would be exempt.

Decision:

The tribunal noted that the services provided by Planet Sport were paid for by the parents of pupils. Although these services were reviewed by OFSTED, this was as part of the overall inspection of each school in which they operated. Planet Sport was therefore not regulated by OFSTED and even if the staff were subject to regulations, their supply was not 'state regulated'. Furthermore, the contribution to the welfare of the children was only a 'by-product' of the essential services of sports coaching. The tribunal concluded that the services provided by Planet Sport did not fall within the exemption.

Comments - Many companies supply services which arguably enhance the welfare of their recipients, particularly children. This case confirms that the exemption will only be available in a narrow range of situations which will depend on both the identity of the service provider — which must be state regulated — and the type of services they supply.

Planet Sport (Holdings) Ltd v HMRC TC3024

Election to waive exemption

The taxpayer had failed to account for input tax on the sale of properties on which he had elected to waive the exemption. Mr Brinkard had purchased land and then developed it into small industrial units, which he had successfully sold in the form of 999 year leases. He had been advised to register for VAT and to waive the exemption in order to recover any VAT incurred on the cost of the development.

Unfortunately, half of the proceeds of the sale were not accounted for by the taxpayer's lawyers. As a direct result, Mr Brinkard did not have sufficient funds to pay the input tax due under the grant of the leases — except one which had already been accounted for. HMRC had mistakenly registered and then de-registered a company owned by the taxpayer and so he argued that the election was not valid. However, the tribunal pointed out that the mistakes made by HMRC had been corrected by the time the leases were granted, at which time, another notice to waive exemption had also been received. Furthermore, the appellant's contentions that his signature had been forged on the election were robustly rejected, as there was ample evidence that he had always intended to elect. In particular, it 'did make sense … for the VAT election to be waived', VAT had actually been paid on the grant of the first lease, and all the invoices on the other leases (on which the VAT remained due) had been prepared on a VAT inclusive basis.

Decision:

The appeal was dismissed but the tribunal urged HMRC to seek to recover the tax in a 'considerate manner' and not to 'simply remit the decision to computers in the “collection section'''.

Comments - Although the application of the law to the facts was straightforward, the tribunal's concluding remarks suggest that HMRC may be expected to show leniency in cases where the letter of the law could lead to severe hardship.

Michael Brinkard v HMRC TC2998

Application for disclosure of documents

Two companies reclaimed input tax. HMRC rejected the claims on the grounds that it appeared that the transactions were connected to MTIC fraud. The companies appealed, and lodged an application for HMRC to disclose various documents, including 'a copy of all of the respondents' policy documents in relation to “contra-trading” and the allocation of alleged tax losses'.

Decision:

The First-tier Tribunal dismissed the companies' applications. Judge Sinfield held that 'the appellants' submission that HMRC cannot deny the appellants' right to deduct input tax on goods without allocating the amount of the VAT loss to the appellants' input tax claims and notwithstanding the possibility of double or multiple recovery of the VAT loss is unsustainable'.

Comments - The First-tier Tribunal rejected the companies' contention that HMRC should be required to disclose a large quantity of policy documents relating to MTIC fraud. Judge Sinfield's comments are self-explanatory.

Abbott International Trading Ltd v HMRC (and related appeal) (TC02893

Treatment of gaming machines

The Rank group ran gaming machines. The issue was whether the takings from those machines benefited from the VAT exemption available to the 'provision of any facilities for the placement of bets' (VATA 1994 Sch 4 Group 4 item 1). This in turn depended on whether the machines fell within the exclusion to the exemption set out in note 3 to item 1. The exemption did not apply where 'the element of chance in the game is provided by means of the machine'. The appeal concerned multi-terminal systems, in which several terminals (i.e. gaming machines) are served by a single remote 'random number generator' (RNG).

Decision:

Contrary to the VAT and Duties Tribunal and the Court of Appeal (in its earlier decision), the Court of Appeal focused on the fact that the language of note 3 had been imported from the Gaming Act 1968 s 26. The court noted that 'the control that Part III sought to impose was on the availability for use by the public of mechanical equipment providing the opportunity for playing of games of chance when the element of chance was provided by the equipment so used'. Consequently, the purpose of Part III could not have been to create an optional regime which suppliers could opt out of by locating RNGs outside terminals. The fact that a single RNG served several terminals could not 'make a material difference'. And so, from a 'substance' point of view, each terminal and the single RNG could together constitute a 'machine within s 26'. As the definition of a 'gaming machine' in note 3 was drawn directly from s 26, 'gaming machine' in note 3 should be interpreted in the same way.

Comments - The relevant VAT provisions were amended in 2005, so the distinction between gaming machines is no longer relevant. That said, HMRC stood to lose £1bn on this and related appeals. The court chose to adopt a purposive interpretation, refusing to be tied by physical technicalities. Taxpayers hoping to avail themselves of a tax treatment on the basis of a physical technicality should be wary of this precedent.

HMRC v Rank Group PLC (CA)

Cultural services exemption

A university students' union appealed against a ruling by HMRC that its entertainment events (mainly balls) were taxable supplies. The union contended that these events were exempt from VAT, either under the 'cultural services exemption' (VATA 1994 Sch 19 Group 13 item 2(b)) or under the 'fundraising exemption' (article 13A(1)(o) of the Sixth VAT Directive). The executive committee of the union (which was responsible for the day-to-day management) included nine 'sabbatical officers' (mainly graduates) who were paid a salary equivalent to two-thirds of what they could have obtained on the open market.

Decision:

The Upper Tribunal upheld the decision of the FTT in favour of HMRC in relation to the cultural services exemption, noting that the salaries paid were sufficiently substantial to preclude the union from being administered on an 'essentially voluntary basis'. The tribunal also rejected the union's contention that the sabbatical officers should be regarded as 'amateurs', as they had no relevant experience or qualification and were all students or ex-students.

Fundraising events are exempt provided that the exemption 'will not cause distortion of competition'. The tribunal stressed that it is not necessary to show that there is actual competition between two activities, provided that the potential for competition exists. Whether this potential existed in the present case was a question of fact which therefore should be remitted to the First-tier Tribunal.

Comments - The cultural services exemption is claimed by a number of institutions in the UK. This case confirms that, although a nominal fee paid to executives will not preclude the exemption from applying, a proper salary (even substantially lower than market value) will.

Loughborough Students' Union v HMRC (Upper Tribunal)

Schmelz- practical impact (Lecture B809 – 17.31 minutes)

Removal of the UK registration threshold for overseas business

If an overseas business makes taxable supplies of goods or services in the UK it will need a UK VAT number with effect from 1 December 2012.

Under previous legislation, there was no requirement for an overseas business to VAT register if taxable sales in the UK were less than £77,000 in the previous 12 months and were expected to be less than £77,000 in the next 30 days i.e. an overseas business was entitled to a VAT threshold in the UK the same as a UK based business.

From 1 December 2012, VATA 1994, Schedule 1A reduced the registration threshold to zero for overseas businesses. So £1 of UK taxable income will create a UK registration obligation for an overseas business.

What exactly is an overseas business?

The exact phrase is NETP (Non-Established Taxable Person) and you can be a NETP if you are based in an EU or non-EU country. The phrase basically means the business is ‘not normally resident in the UK, does not have a UK establishment and, in the case of a company, is not incorporated here.’ (HMRC Notice 700/1, para 9.1)

A UK establishment generally exists if the business’ ‘central administration’ is in the UK or ‘essential management decisions’ are taken in the UK, or it has a ‘permanent physical presence’ in the UK, ‘with the human and technical resources to make or receive taxable supplies in the UK’ (extracts are from Notice 700/1, para 9.2).

Schedule 1A situations

Land services

The place of supply of land related services is where the land is situated. This can often create a Schedule 1A registration obligation.

Illustration 1

George is a builder resident in France and is doing two jobs in the UK:

- He is going to work for a building contractor who is VAT registered in the UK in connection with a new restaurant being built in London;
- He is also going to build a new conservatory for a private house owner, charging £5,000 for his labour. (the house owner will buy the materials separately from B&Q).

The place of supply for a 'land' service is where the land is based i.e. UK in both cases but the VAT is dealt with by the customer with the reverse charge calculation if he has a UK VAT number i.e. in relation to the work on the restaurant for the building contractor. This is because of the extension of the reverse charge to land services where the customer has a VAT number.

Since 1 December 2012, however, he has needed a VAT registration number in relation to the private job – the date of registration is when he knows he will be making taxable sales in the UK in the next 30 days. However, George will still not charge VAT to the building contractor in relation to the restaurant job where the reverse charge is still carried out by the contractor.

As a practical challenge, what is the situation as far as George's expenditure in the UK is concerned? If he didn't have a UK VAT number and wanted to recover VAT on his UK costs in relation to his restaurant contract e.g. hotel bills, van hire costs, subsistence expenses, then he would need to submit an overseas VAT repayment claim to HMRC's office in Londonderry (by making an electronic claim via his own tax authority in France). But with his new VAT number after 1 December, he can recover all of the VAT on his UK expenses (subject to normal rules) as input tax in Box 4 of his return.

Performance services

Another batch of services affected by the changes relate to B2C sales of what are known as the 'performance' services e.g. catering services.

For these services, the relevant issue is where the service is performed rather than where the supplier is based.

Illustration 2

A UK diner has asked the proprietor of their favourite restaurant in Paris to cater for a family party in London. The trip will cover a whole weekend and the fee quoted is £8,000.

This is a catering service and until 30 November, the restaurant owner could have relied on the UK registration threshold of £77,000 to avoid registering for VAT in the UK. Unfortunately the zero VAT threshold from 1 December 2012 means the French proprietor is required to become VAT registered and charge UK VAT at 20% on the catering service.

Selling goods

Moving goods cross border does not normally bring Schedule 1A into play. This is because the place of supply of goods is generally the country of departure. So when a German company sells goods to a registered UK company the place of supply is in Germany i.e. country of departure. The supply will then be zero rated in Germany as the UK customer is VAT registered. UK law then provides that the UK customer must account for UK acquisition VAT on their German purchase.

If the German supplier was selling goods to unregistered UK individuals they are still making a German supply i.e. country of departure. German VAT would then be chargeable as the UK customer is not registered. Schedule 1A would not be in point although the German Co may have a UK registration under our distance selling rules (Schedule 2).

It is only when the goods are supplied in the UK by an NETP that Schedule 1A needs to be given due consideration.

Illustration 3

Jan is resident in Holland and comes to the UK for about three months a year to do cricket coaching for players at local clubs – he also buys and sells a small amount of cricket equipment e.g. bats, balls, pads etc. He is a sole trader, so his coaching work is VAT exempt under the 'private tuition' rules and is therefore ignored as far as either the VAT registration limit or output tax is concerned.

However, he buys the kit items from a supplier in Northampton and then sells them separately – about £3,000 of sales a year and he makes about £1,000 net profit. With effect from 1 December, if he applies the new legislation correctly, he will need a UK VAT number because he is a NETP making taxable sales in the UK above the zero threshold.

Holiday rentals

Holiday rentals are standard rated in the UK. Where a UK client has rentals from a UK holiday property we would have to consider the £79,000 registration limit and decide whether VAT should be accounted for on the holiday rents.

When a non-established person has rental from a UK holiday home they will have a UK registration obligation under Schedule 1A.

They may however be able to create a UK establishment by appointing a UK agent to manage the property. VAT Notice 741A Para 3.4.1 states that the property itself does not create a UK establishment but a UK managing agent would.

If UK clients are leaving the UK for an extended period and they decide to long let their property there are no VAT issues as the lets are exempt. If however they decide to go for short holiday lets then we need to ensure they appoint a UK agent so they get access to the £79,000 VAT registration limit. Failure to appoint an agent may well create a UK registration obligation under Schedule 1A.

Illustration 4

A French individual buys a property in Cornwall for holiday letting. If they appoint a UK agent to manage their property they will only need to register for UK VAT when they breach the £79,000 limit.

If they appoint a French agent to market the property to French people then Schedule 1A is likely to be in point.

Getting a UK VAT number

The end result of the above analysis is that our French builder, French chef, Dutch cricketer etc will all need a UK VAT number for their various activities. How do they get it? In basic terms, there are four possibilities:

They could deal with the registration issues themselves by directly liaising with HMRC's NETP Unit in Aberdeen (Ruby House, 8 Ruby Place, Aberdeen. AB10 1ZP). NETPs can also register by using HMRC's new online service, effective from 5 November 2012.

They could appoint a UK tax representative to deal with their affairs – this is not the most desirable outcome because the representative is 'jointly and severally liable for any VAT debts' incurred by the business (HMRC Notice 700/1, para 11.1).

This procedure involves the completion of a VAT1TR form to give authority to the representative and all matters are dealt with by HMRC's Registration Service in Wolverhampton rather than Aberdeen (Deansgate, 62-70 Tettenhall Rd, Wolverhampton. WV1 4TZ). An NETP using the online registration service can provide details of its tax representative at the time of completing the online form.

Appointing a UK tax agent is another option – and means the agent will be responsible for maintaining VAT records and accounting for UK VAT on behalf of the NETP – but will not be jointly and severally liable for any VAT debts. Tax agent registrations are again dealt with by HMRC's Wolverhampton office rather than Aberdeen. A letter of authority needs to be completed and signed by the client to confirm its appointed agent with HMRC.

Exemption for zero-rated sales

A NETP business that only makes zero-rated sales in the UK will not need to register for VAT if it does not want to do so. VATA1994, Sch. 1A, para. 13(1) and (2) will allow a business to apply for exemption in such cases.

Removal of the EU registration thresholds for a UK business

The recent ECJ decision in the case of Schmelz confirmed that only businesses established in a Member State can benefit from its domestic VAT registration threshold – hence the introduction of Schedule 1A in the UK from 1 December 2012.

When advising UK clients we should always assume that they have a zero registration threshold in other member states. So any taxable income in a member state is likely to trigger an overseas registration obligation and local advice should be sought.

Thankfully business to business (B2B) services will never create an overseas registration obligation for a UK service provider – their EU customer should reverse charge the supply. If their EU business customer is not VAT registered then the supply counts towards their customers registration threshold.

Illustration 5

An accountant from Leicester is about to invoice 4 different clients.

1. A French company (VAT registered in France)
2. An Irish farmer (not VAT registered)
3. A British client who has now retired and lives in Spain
4. A British client who has now retired and lives in Jersey

Invoice to French Company (VAT registered)

This is a B2B supply and as such the place of supply is France i.e. where the client belongs. The supply is therefore outside the scope of UK VAT. The invoice should be raised without VAT and should include narrative informing the French Company of their reverse charge obligations.

The invoice should be recorded on the accountants EC Sales list using Indicator 3 to denote “service”.

Invoice to Irish Farmer (not VAT registered)

This is a B2B supply and as such the place of supply is Ireland i.e. where the client belongs. There is no requirement that the recipient be registered for VAT – they just need to be in business. The supply is therefore outside the scope of UK VAT.

The invoice should be raised without VAT and should include narrative informing the Irish farmer of their reverse charge obligations. No entry is needed on the EC Sales List as the farmer is not registered for VAT.

This B2B supply should not create an Irish registration obligation on the Leicester accountant – B2B supplies are a mandatory reverse charge throughout the EU.

As such the Irish farmer will have to include the invoice in their registration thresholds – even though it is a purchase! When the reverse charge applies it is effectively treated as the recipient's income and may trigger an obligation to register for the Irish farmer when added to their own taxable income.

Invoice to British client living in Spain

This is a business to consumer (B2C) supply as the client is not a relevant business person. Standard rated VAT will be due.

Invoice to British client living in Jersey

This is a business to consumer (B2C) supply as the client is not a relevant business person. However, Schedule 4A Para 16 shifts the place of supply to where the non-EU customer belongs. Para 16 covers many services including accountants, lawyers and consultants. Consequently this invoice is outside the scope of UK VAT.

Land related services fall outside of the normal B2B rules and could easily create an overseas registration obligation.

Illustration 6

An architect from London has an excellent reputation for modernising homes in and around London. He has recently seen an increase in requests from UK clients to assist with their modernisation plans for their holiday homes – some of which are outside the UK.

The architect's services are land related and as such the place of supply is where the land is situated. The architect's clients would appear to be private individuals so there is no question of the reverse charge discharging the architects VAT registration obligations when he does work on properties located in another member state.

Three parties in a deal – practical VAT challenges **(Lecture B810 – 13.20 minutes)**

Opportunity for VAT credit on rebates by manufacturers

UK law allows a business in a direct relationship with a customer to adjust the VAT originally accounted for in the case of a post-supply adjustment to the payment initially made by the customer. However, the

legislation is silent on the position where a manufacturer, which has no direct relationship with the final consumer of its products, makes a post-supply payment.

At Budget 2013 the Government announced its intention to legislate to allow manufacturers to adjust their VAT to take account of refunds they make to final consumers. In this context the term 'refund' refers to a payment made by a manufacturer directly (or via a third party) to the customer of a retailer. These payments may be made for a number of reasons, for example:

- faulty products;
- damaged products;
- customer dissatisfaction.

Normally when a retailer sells goods to a customer, it is the retailer that refunds money to the customer if those goods are returned, or a retrospective reduction in price is agreed. Where the goods are subject to VAT, the retailer is entitled to make an adjustment under regulation 38 of the VAT Regulations 1995 ("regulation 38") and reclaim the VAT declared to HMRC on the original transaction. A VAT registered purchaser must make a similar adjustment to any VAT reclaimed on the goods.

However, sometimes the purchaser seeks a refund of some, or all, of the price paid for the goods from the manufacturer and not from the retailer. This might happen, for example, when there is a major fault in the goods. Regulation 38 does not explicitly address this situation.

The measure seeks to equalise the VAT treatment as far as possible and ensure that UK law expressly accords with EU law. The legislation to implement this change will take effect in 2014.

Note – the European Court of Justice (ECJ) concluded in the case of Elida Gibbs (C-317/94) that a manufacturer was entitled to adjust its VAT to take account of refunds paid directly to final consumers under a promotion scheme, even though the original output tax had mainly been declared on sales to retailers. In that case a consumer could send a coupon to the manufacturer and claim a cash refund of part of the price paid to the retailer.

HMRC had not interpreted the judgment as applying where the manufacturer made a refund in cases of, for example, faulty or damaged goods. In such cases the refund by the manufacturer was viewed as compensation or an ex gratia goodwill payment and thus outside the scope of VAT. Following representations, HMRC have reviewed this interpretation of the law and now accept that in certain situations the manufacturer is entitled to adjust the VAT it has accounted for when it makes a refund direct to the retailer's customer.

Note - the change will be made by amending the Value Added Tax Regulations 1995 (1995/2518).

Intended outcome

The objective of the change is to ensure that the net VAT accounted to HMRC on any given supply of goods is proportionate to the total consideration paid by the consumer for the goods, after adjusting for any refund made.

Key points

The changes will only apply to the extent that the refund relates to the original purchase price paid by the consumer. Therefore payments that relate to compensation for a consequential loss or the amount of a refund that exceeds the total consideration paid for the goods will not be covered by the proposed change.

In effect, the consumer has to be put in the position of never having purchased the product (i.e. they return the goods and receive a full refund of the purchase price) or, of having paid a lower price for the product (i.e. they retain the product and receive a partial refund of the purchase price).

The provision of a non-monetary credit such as the issue of a voucher by a manufacturer to a consumer would therefore not be covered by the definition of "refund" as this entails a discount against a future purchase rather than a reduction in the original consideration.

Payments made to the customer or third parties to cover the cost of repairs to the goods sold by the manufacturer will not be covered by the changes.

Rooms provided with catering (R&C Brief 02/13)

HMRC have issued the above Brief concerning the VAT treatment of rooms provided in hotels etc for the purpose of supplies of catering. HMRC's view is that the provision of accommodation in a hotel, inn, boarding house or similar establishment for the purpose of catering is standard rated, regardless of who is providing the catering. This Brief has been issued following the publication of an updated Notice 709/3 Hotels and Holiday Accommodation.

When the previous edition of the guidance was written, HMRC's view was that where both the room and catering were supplied by the hotel or similar establishment, the whole supply (including the provision of the room) would be standard rated. However, where the catering was supplied by a different person, the supply of only the room by the hotel would be exempt (unless the hotel had opted to tax the property in question, which would make the room only charge standard rated). HMRC subsequently changed their view on this second point but did not update their guidance. They now believe that the provision of accommodation in a hotel, inn, boarding house or similar establishment for the purpose of catering is standard rated, regardless of who does the catering. The implementation date of the change in policy was 22 January 2013 – no retrospective assessments will be raised on incorrect exemption before this date.

Comment:

The revised interpretation in relation to supplies of room hire for catering purposes only applies to hirings in ‘a hotel, inn, boarding house or similar establishment.’ It would not apply to e.g. a room hire charge made by a village hall, football/social club, freemasons club even though the purpose of the event is linked to catering because these venues are not a hotel/inn etc.

HMRC Notice 709/3, section 2, describes a ‘similar establishment’ as follows:

Establishments with similar characteristics to hotels, inns and boarding houses; and any premises, in which furnished sleeping accommodation is provided, that are used by or held out as being suitable for use by visitors or travellers (but not if such use is only occasional).

This includes…….motels, guest houses, bed and breakfast establishments, private residential clubs, hostels and serviced flats (other than those for permanent residential use)

As a separate point, room hire charges made by a hotel for e.g. a VAT training course or a conference would continue to be exempt from VAT (supplies of tea/coffee and biscuits would be ignored) unless the hotel has made an option to tax election in relation to the property (HMRC Notice 709/3, para 4.1).

<u>Output tax challenge with three parties</u>

Example 1

Jean runs a hairdressing salon and is VAT registered. She shares the premises with five self-employed stylists who are not VAT registered. The stylists pay her 50% of the money they collect from customers for the use of the facilities in the salon. A visiting HMRC officer claims this accounting treatment is wrong – and that output tax is due on the entire money paid by the customers. Is the officer correct?

<u>Joppa Enterprises Ltd (VTD 20,180) – three parties</u>

VAT can be quite complex when three different parties are involved in a transaction, and it is necessary to establish who is acting as the principle and needs to account for output tax.

The case of Joppa Enterprises Ltd (2009) (CSIH 17) was heard in the Scottish Court of Session and related to services provided by a massage parlour, and whether the parlour was liable to account for output tax on the full door money paid by the customer, or only on the net balance of the money it received after having paid a percentage of the fee to the self-employed masseuses.

The approach adopted by the tribunal was to consider the perception of the customer paying his money – who would clearly identify that he was making payment to the business rather than the masseuse.

The entry fee included a range of facilities offered by the parlour, including the lounge, newspapers, television, refreshments as well as the services of the hostess. Output tax was payable on the full entry fee by the parlour.

Message – A great deal of care is needed to assess contracts and look at the customer perception of an arrangement.

In the case of Jean, it is important that she has a contract in place with each stylist to confirm that she is providing the services of the salon (towels, chair, reception facility, shampoos etc) to each stylist, even if the basis of payment is linked to the amount of money earned by the stylist.

Contributed by Neil Warren