Tolley®CPD

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Personal Tax

Duty to give tax advice

The defendant was a firm of chartered accountants which had acted for the claimant in the provision of accountancy services and general tax advice. The claimant had established a successful retail fashion business which was an English registered company. There were plans to sell the company. The claimant wished to avoid paying capital gains tax (CGT) on the disposal of his shares. He held discussions with the defendant and two firms that offered tax advice. The possibility of using a bearer warrant scheme (BWS) was not suggested to him. A BWS aimed to change the situs of the shares prior to their disposal in order to take advantage of s 12 of the Taxation of Chargeable Gains Act 1992, which provided that individuals who were resident, but not domiciled, in the UK would not be charged in respect of assets situated outside the UK except insofar as the proceeds of sale were remitted to the UK. In March 2005, primary legislation came into effect which blocked BWSs. In the event, the claimant did not enter into a BWS. In April 2005, the company was sold for £22m. The claimant's share of the proceeds of sale was £8·5m. In August, the claimant, on the advice of a tax adviser, entered into a tax scheme known as a Capital Redemption Plan (CRP). The CRP was an artificial tax scheme designed to create a capital loss which could be set off against the relevant liability to CGT which it was sought to avoid. The Revenue and Customs Commissioners challenged the effectiveness of the CRP and an agreement was reached between them and the claimant under which the loss produced by the CRP was disallowed and the claimant agreed to pay penalties and interest. The claimant issued proceedings against the defendant alleging negligence. As part of the claim, he sought to recover the fee and interest he had paid to the Revenue, but not the interest. He accepted that the defendant was a firm of generalist accountants and that he had never asked them to give him tax planning advice on possible ways of minimising or eliminating the CGT applicable to his disposal of the shares. However, he contended that, as reasonably competent chartered accountants, they had been obliged to have advised him that he had had, or very probably might have had, non-domicile status due to his Iranian origin which carried with it significant tax advantages and that he should have sought and obtained specialist tax advice. Had he received that advice, he would have instructed such a specialist and been advised to enter into a BWS which would have been implemented before such schemes were blocked. The judge held that the defendant had been negligent. He interpreted the defendant's retainer letter as not imposing any obligation on them to advise the claimant as to how he might minimise his tax liabilities unless they were specifically requested to do so. However, he found, on the evidence, that there had been a clear and mutually accepted understanding between the parties, based on a course of conduct, that the defendant had always been required to consider the claimant's best tax position and to give appropriate advice, including on how to reduce his tax liability, even when such advice had not been expressly requested. In particular, the judge found that by October 2004, when a meeting had been held between the parties (the October meeting) to discuss (on the judge's findings) the CGT liabilities which would arise on the sale of the shares and how the claimant might reduce that liability, the defendant had come to share the claimant's expectation that they would give tax planning advice to the claimant even when not requested to do so. Furthermore, even if there had been no pre-existing duty before the October meeting, the defendant had assumed responsibility and therefore come under a duty to give tax planning advice because of the nature of the meeting. The obligation on the defendant to give tax planning advice to the claimant had included advising him that he was or might have been a non-

domicile (based on the defendant's knowledge of the claimant's family history which had to have led them to realise that he had probably retained his Iranian domicile), which carried with it significant tax advantages, and that he should obtain tax advice from a non-domicile specialist. The judge awarded the claimant damages for the CGT he had been obliged to pay on the sale of his shares, the cost of entry to the CRP and the amount of interest payable on the CGT. The defendant appealed.

The issued for determination were: (i) whether the judge had erred in having found that their retainer had extended to advising and assisting the claimant generally in relation to his tax affairs including CGT planning on the sale of the shares even when they had not been requested so to do; and (ii) whether the duty to give general tax advice at the October meeting could be said to have included a duty to give advice to the claimant that he was a non-domicile and that that status carried with it potentially significant tax advantages.

The appeal would be allowed.

Decision:

(1) The judge had correctly interpreted the retainer letter as having not imposed any obligation on the defendant to advise the claimant as to how he might minimise his tax liabilities unless they were specifically requested to do so. It was clear from the terms of the letter and from the context of the relationship that the defendant had been acting as general accountants to the claimant and his company. As such, they had been charged with preparing annual tax returns and with advising on the availability of reliefs in connection with their annual tax liabilities. Any more specialised services than that would have had to have been specifically requested and it would have been a matter for the defendant to decide whether, and if so, how such a request would be accommodated. It was established law that there was no such thing as a general retainer and any consequent duty of care depended upon what the professional was instructed to do. An accountant in the position of the defendant was not, therefore, under a general roving duty to have regard to and to advise on all aspects of the claimant's affairs absent a request to do so. The claimant had accepted that he had never asked the defendant to give him tax planning advice on minimising or eliminating the CGT applicable to his disposal of the shares. Under the terms of the retainer therefore, the defendant had not been required to give such advice. The defendant was not a specialist tax planner and had never offered to give the claimant such advice. A more extensive tax planning service than the conventional forms of tax planning advice listed in the retainer letter had been available only on request but had never been requested by the claimant. A fundamental variation in the terms of the retainer, as found by the judge, could not be inferred from any evidence that he had referred to. The judge's conclusion that the defendant had to have been taken to have assumed a positive duty to give tax planning advice by the time of the October meeting was not sustainable.

Regent Leisuretime Ltd v Skerrett [2006] All ER (D) 313 (Jul) applied.

(2) It had been common ground that the defendant had not been aware of the BWS or any other tax efficient means of changing the situs of the shares to foreign assets and that such knowledge would not have been possessed by a reasonably competent generalist accountant at the relevant time. The reasonably competent accountant setting out to advice the claimant of the tax consequences of the sale of the shares in an English registered company would not have been under any obligation to raise for

discussion the claimant's domicile unless it had been relevant to the CGT liability of the disposal. The accountant would have known that it had given the claimant no tax advantages in relation to the sale of the shares unless the situs of the shares could have been changed. As that was something which the defendant had neither known or could have been expected to have known was achievable, there had been no reason to mention the matter still less a liability in negligence for not having done so. There had been no reason, still less any obligation, on the defendant to have raised the claimant's non-domicile status at the October meeting when the only issue for discussion had been the CGT payable on the disposal. The same applied to the contention that the defendant should have told the claimant that his probably non-domicile status had carried with it significant tax advantages. Those had not been advantages available to the claimant on the sale of UK registered shares and, in the absence of any claim that the defendant should have known and advised the claimant that it would or might be possible to change the situs of the shares without triggering a charge to CGT in the process, it was difficult to understand why they had been under any legal duty to have brought the existence of those advantages to the claimant's attention. The competent accountant would not have believed that they had existed. There could not have been any duty on the defendant to have advised the claimant to consult a non-domicile specialist if the defendant, in the circumstances, had not been under a duty to draw to his attention any significant tax advantages derived from his status which might have been relevant to the sale of the shares. The defendant had alerted the claimant to the fact that various tax saving schemes might have been available. They had not known what those schemes were, nor could they have been expected to do so. The claimant had known about the tax charge and had chosen not to follow up on the availability of tax saving schemes. The defendants had discharged their duty.

Hurlingham Estates Ltd v Wilde & Partners [1997] STC 627 considered.

Comments - The Court of Appeal found in favour of the advisers, but the proceedings may have been avoided if the retainer had been clearer. Frank Haskew, head of the ICAEW Tax Faculty, said: 'Firms providing general advice should be careful to specify in an engagement letter what services they will provide to a client.'

Rob Morris, partner at RPC, said: “This ruling is a huge boost for accountancy firms that haven't been recommending complex tax planning products as part of their job. It means that they will not be liable for failing to recommend a complex tax planning product unless they specifically offer this service to clients.

“The decision is also significant for professional firms that build a close relationship with a client over a number of years without updating their engagement terms. The court was reluctant to find that the accountant assumed a duty to volunteer advice on issues it had not expressly agreed to in its written retainer.”

H Mehjoo v Harben Baker (a firm) and Harben Baker Ltd, Court of Appeal (A2/2013/1863)

Tax cap not taking account of tax paid in other EU jurisdiction

Ms Bouanich was tax resident in France and held shares in a company listed in Sweden. The so-called 'tax shield' applicable under French law, which capped tax at 60% or 50% of income received during a tax year, did not take into account tax paid in Sweden.

Decision:

The CJEU held that this was contrary to the principles of freedom of movement of capital and of establishment (TFEU arts 49 and 63). Under the Franco/Swedish double tax agreement (DTA), the dividends Ms Bouanich received from Sweden were subject to withholding tax in Sweden and the French tax authorities included the Swedish dividends in her taxable base. Then, after calculating the gross amount of income tax by applying the progressive scale to the taxable base, the French tax authorities set against that gross amount a tax credit equal to the amount of withholding tax to which Ms Bouanich had been subject in Sweden. The court noted that this method of calculating the tax liability meant that individuals receiving dividends from a company established in France and those receiving dividends from a company established in Sweden were in objectively comparable situations as regards their tax liability. The fact that the tax paid in Sweden was excluded from the taxes taken into account for the purposes of applying the tax shield amounted to a less favourable tax treatment for taxpayers such as Ms Bouanich, who reside in France and receive dividends from companies established in Sweden; and that it was liable to discourage natural persons subject to unlimited income tax in France from investing their capital in companies established in another member state or from establishing themselves there. The restriction could not be justified by the need to maintain the coherence of the tax system — as there was no link between the shield and a particular levy — or a balanced allocation of taxing rights when the DTA already provided for this allocation.

Comments - The notion of the tax shield does not exist under UK law, but the case will be highly relevant to taxpayers resident in EU jurisdictions which do implement a form of tax shield.

Margaretha Bouanich v Directeur des Services Fiscaux de la Drôme (C-375/12)

Pension Reform

A consultation document ‘Freedom and choice in pensions’ has been published to build on reforms announced in the Budget by radically increasing the choice and flexibility available to individuals when they come to access their defined contribution pension savings.

Under the new system, everyone will be entitled to flexibility, regardless of their total defined contribution pension savings. Individuals will be able to draw down on these pension savings whenever and however they wish after the age of 55. Any amount they draw down will be treated as income and therefore subject to their marginal rate of income tax in that year rather than the current 55% charge for full withdrawals. The tax-free pension commencement lump sum (usually 25% of an individual’s pot) will continue to be available. All individuals will have access to their savings from age 55, subject to their scheme rules.

The following examples are given:

Case A

Ms A is 57 and has a salary of £45,000 per annum from her employer. She has a defined contribution pension pot of £100,000. She chooses to cease contributing to her pension - takes her 25% tax-free lump sum (£25,000) and invests the remaining £75,000. At age 66 she retires and chooses to use her pot (which has now grown to £80,000) to purchase an annuity. She will therefore receive £5,200 per year on top of her State Pension of £7,500. This means that she would be liable for the basic rate of income tax on £2,700 (based on an assumed personal allowance of £10,000).

Case B

Mr B is 68 and has an income of £7,500 per annum from his State Pension. He has a defined contribution pot of £40,000. He takes a tax-free lump sum of £10,000, and chooses to invest the rest through a drawdown product. He takes £2,000 from his drawdown fund each year. This keeps him below the personal allowance. He therefore pays no tax on his income.

Case C

Mrs C is 62 and has no other income, but does have a £20,000 defined contribution pension pot. She withdraws all £20,000 in one year and places £15,000 of this in her ISA. When withdrawing the £20,000 from her pension fund, she receives 25% (£5,000) tax free and pays no tax up to her personal allowance of £10,000. She therefore pays 20% tax on the remaining £5,000.

Case D

Mr D is 66 and has an income of £7,500 per annum from his State Pension. He has a defined contribution pot of £100,000 and decides to take £55,000 from his pension pot, which includes his 25% tax-free lump sum (£25,000), to pay off his mortgage. Of the £30,000 above the lump sum, £2,500 will be taxed at 0% as, together with his State Pension, it falls within his £10,000 personal allowance. The remaining £27,500 would then be taxed at 20%. In year 2, Mr D takes the full £45,000 left in his pension pot. Assuming the tax thresholds remain unchanged in year 2, the first £2,500 and his State Pension will be taxed at 0%, the next £31,865 will be taxed at 20% and the final £10,635 will be taxed at the higher rate of 40%.

Access

The government proposes to increase the age at which an individual can take their private pension savings at the same rate as the increase in the State Pension age. It is proposed that the Government should wait until 2028 (when the State Pension age will rise to 67) to fully implement this change. From 2028, people will not be able to draw their private pension benefits without a tax penalty until age 57, whether or not this is the point at which they stop work. From then on, the minimum pension age in the tax rules will rise in line with the State Pension age so that the age is always ten years below the state pension age.

The new minimum age will apply to all pension schemes which qualify for tax relief. However, views are welcomed on whether this approach is correct.

Defined benefit schemes

Currently, members of a defined benefit pension scheme have the right to a Cash Equivalent Transfer Value (CETV). This allows them to transfer to any other pension scheme, subject to certain conditions. The government intends to introduce legislation to remove the option to transfer from a public service defined benefit scheme to a defined contribution scheme, except in very limited circumstances.

The government is also open to any views from respondents on how best to address the issue of transfers from non-public service defined benefit to defined contribution schemes under the new tax system.

Specifically, the government is open to options including:

- legislating to remove the right of all members of defined benefit schemes to transfer to a defined contribution scheme, except in exceptional circumstances, as proposed with public service defined benefit schemes. This is the government's starting point, unless the issues and risks around other options can be shown to be manageable;
- continuing to allow members of defined benefit schemes to transfer to defined contribution, as now, but requiring that any funds which have been transferred are ring-fenced by the receiving pension scheme and subject to the existing tax framework for defined contribution. This option preserves but does not extend existing flexibilities within the pension system, and therefore presents no additional economic risks; however it may introduce additional complexity and burdens on scheme sponsors and HMRC, and the government would welcome views on this point;
- placing a cap on the amount that people in defined benefit schemes can transfer to defined contribution schemes each year;
- continuing to allow transfers, but requiring that any transfer to a defined contribution scheme must be approved by the defined benefit scheme trustees before it can be made
- leaving in place the existing flexibility for members of private sector defined benefit pension schemes to switch to defined contribution schemes, thereby effectively extending to them the full flexibilities described in the document. The government is open to this option, given its attractions in principle, but only if it is clear that this would not create significant risks for the UK economy.

Budget changes - pension flexibility and changes to Finance Bill 2014

On 27 March the government announced it would bring forward legislation in Finance Bill 2014 to ensure that people do not lose their right to a tax-free lump sum if they would rather use the new flexibility this year or next, instead of buying a lifetime annuity.

HMRC has today provided more information to help people who want to use the new flexibility. This information is for people who have:

- received a tax free lump sum after 27 March 2014

- received a tax-free lump sum on or before 27 March 2014, and either
  - cancelled an annuity contract within the cooling-off period on or after Budget day (19 March 2014) that was linked to that lump sum
  - not yet decided how to access the rest of their pension savings

Further detail is set out below on whether or not the unravelling of actions that were taken shortly before the Budget changes were announced will give rise to a tax charge. This information relates to how the tax rules will apply. The options available to you will depend on what your pension scheme decides to allow. All references to an annuity mean a lifetime annuity.

Individuals who can already take advantage of the new flexibility

You can already take advantage of pension flexibility in the following circumstances without waiting for changes to the Finance Bill if:

- you have given instructions to receive your benefits but your pension scheme has not paid your tax-free lump sum or set up your annuity
- your pension scheme has paid you your tax-free lump sum, and bought your annuity but you cancelled the annuity contract within the cooling-off period and entered into drawdown with your pension scheme
- your pension scheme has paid you your tax-free lump sum, your annuity contract is set up but your total pension rights (in all pension schemes including those in payment and any tax-free lump sums) are £30,000 or less and you meet all the requirements to immediately take the annuity as a taxed lump sum (the annuity contract must be turned into a lump sum, which is taxed, not cancelled in these circumstances)
- your pension scheme has paid you your tax-free lump sum, your annuity contract is set up but the value of your annuity is £10,000 or less and you meet all the requirements to immediately take the annuity as a taxed lump sum (the annuity contract must be turned into a lump sum (which is taxed), not cancelled, in these circumstances)

Individuals who will be able to use the new flexibility

The government will introduce legislation in Finance Bill 2014 so that if you want to take advantage of pension flexibility after changes are made in Finance Bill 2014 and you have recently received your lump sum, it will remain tax-free in the following circumstances:

- your pension scheme has paid you your tax-free lump sum, you have bought an annuity but cancelled the annuity contract within the cooling-off period and both the annuity purchase price and the lump sum have been paid back to your pension scheme
  - you want to use the pension flexibility that took effect from 27 March 2014 - you will be able to use this flexibility from when the changes become law
  - you want to wait to use the pension flexibility from April 2015 - you will be able to use this flexibility from that date

- your pension scheme has paid you your tax-free lump sum, you have bought an annuity but cancelled the annuity contract within the cooling-off period and while you have kept the lump sum, the purchase price for the annuity either
  - has been paid back to your pension scheme
  - is held temporarily by the firm that arranged your cancelled annuity contract
  - is transferred to another firm in order to access drawdown
    - you want to use the pension flexibility that took effect from 27 March 2014 - you will be able to use this flexibility from when the changes become law
    - you want to wait to use the pension flexibility from April 2015 - you will be able to use this flexibility from that date

If the option of keeping your lump sum is open to you and you decide to do so, you will need to be aware that you will have received the final value of your tax-free lump sum, even if the rest of your fund grows before you take advantage of the new flexibility. On the other hand the tax exemption for the lump sum won't be affected should your fund fall in value by the time you take advantage of the new flexibility.

In practice, it will be up to pension schemes and providers to decide the options under the new flexibility that they will allow so people who want to use the new pension flexibility will find themselves in many different situations. If you have recently received your tax-free lump sum and cancelled your annuity contract or not yet decided how to access the rest of your pension savings, your pension scheme or provider will be able to help you find a solution so that your lump sum remains tax-free. However, even where you can use the new flexibility, you may need to wait for new legislation to take effect to access your funds.

You will also be able to use the pension flexibility from April 2015 if you receive a tax-free lump sum after 27 March 2014 under either:

- the scheme that paid the lump sum
- another scheme to which you have transferred the funds in order to access drawdown

Individuals who already receive their pension income

These changes will not apply to you if you have received a tax-free lump sum, and started to receive an income and the cooling-off period has ended. As set out in paragraph 3.22 of the 'Freedom and choice in pensions' consultation document, you will remain bound by the contract made with your annuity provider.

Protected Pensions

HMRC has reminded those with pension savings of the various schemes that are available to protect existing pension rights.

Pension savings before 6 April 2006
Some people had built up pension pots worth more than £1.5m before 6 April 2006 when the lifetime allowance was introduced. Lifetime allowance protection was introduced so that there was no requirement to pay the lifetime allowance tax charge on pension pots built up before this date. There are two main types of protection for pension pots built up before that date. These are primary protection and enhanced protection

Pension savings before 6 April 2012
The lifetime allowance gradually increased to £1.8m by 2010/11 but from 6 April 2012 the lifetime allowance was reduced to £1.5m. A new form of protection called fixed protection was introduced to protect those who had built up, or thought they may build up, pension pots of more than £1.5m but no more than £1.8m.

Pension savings before 6 April 2014
From 6 April 2014 the lifetime allowance is reduced to £1.25m. A new form of protection called fixed protection 2014 was introduced to protect those who had built up, or think they may build up, pension pots of more than £1.25m but no more than £1.5m.

A further form of protection called individual protection 2014 will also apply from 6 April 2014. IP2014 operates from 6 April 2014 but it will not be possible to apply until August 2014. The opportunity to make a claim for this protection exists until 5 April 2017. For those with pension savings above £1.25m it will provide protection of those savings with a value on 5 April 2014 of between £1.25m and £1.5m. Unlike fixed protection and fixed protection 2014, a person with individual protection 2014 can continue to accrue unlimited further pension benefits or pay contributions without losing their protection.

Salary sacrifice arrangements did not work

The Upper Tribunal (UT) confirmed the decision of the FTT that salary sacrifice arrangements implemented by Reed to avoid income tax and NIC liabilities totalling £158m were not effective.

The decision concerned Reed's employment business, which supplied temporary workers (that were employees of Reed) to clients. Reed had implemented a scheme whereby travel expenses were paid to employees under separate contractual arrangements. This was done on the basis of advice that the payment of travel expenses was subject to PAYE and NIC only under ITEPA 2003 s 72 and deductible under ITEPA2003 s 338.

Decision:

The UT noted that the key to determining whether Reed's employees had made an effective salary sacrifice was to ascertain the true construction of the contractual arrangements. Heaton v Bell [1970] AC 728 was authority for the proposition that 'a mere re-labelling of a part of an employee's salary is insufficient'.

Having reviewed the terms of the employment contracts (including the employee handbook), the UT concluded that whilst employees had agreed to be paid in accordance with the scheme, they had not accepted a reduction in salary.

The UT also held that there was no 'overarching' employment contract which applied between assignments. In the tribunal's view, Reed failed the Nethermere test ([1984] ICR 612), as it did not have any real obligation (such as providing a minimum amount of work) capable of founding mutuality.

In relation to the question as to whether Reed had a legitimate expectation to be treated according to dispensations granted by HMRC, referring to MFK Underwriting [1990] 1 WLR 1545, the UT stressed that 'open dealing on both sides underpins the principle of legitimate expectation'. The UT agreed with the FTT's finding that Reed had been 'less than forthcoming'.

Comments - Employers wishing to implement salary sacrifice schemes should ensure that the contractual documentation clearly sets out the extent of the salary reduction. The case is also a reminder that a ruling from HMRC can only be relied upon if the taxpayer has made an exhaustive disclosure of the relevant facts.

Reed Employment v HMRC (FTC/34/2012)

Employee awards of 'restricted securities' were effective

In the appeal concerned, schemes implemented by UBS and Deutsche Bank (DB) to limit their liability to income tax and NICs on the payment of bonuses.

The UT had allowed the UBS appeal and dismissed the DB appeal; therefore, both HMRC and DB were appellants.

UBS had invited senior employees to elect to receive a proportion of their bonus in shares instead of cash. It had set up an offshore SPV, in which it subscribed for shares with a value equal to its bonus pool. The shares were eventually allocated to designated employees. The rights attached to the shares were meant to ensure that they were 'restricted securities' (ITEPA 2003 s 423). They were subject to a condition as a result of which they may be subject to a 'transfer, reversion or forfeiture', in consequence of which the holder would receive less than their market value. On allocation of the shares to employees, the shares therefore escaped income tax (and NICs).

Decision:

The Court of Appeal rejected HMRC's contention that the scheme implemented by UBS should be recharacterised under the Ramsay doctrine, as it was implemented for tax avoidance purposes. The court accepted that the scheme was motivated by tax avoidance; however, the provisions governing 'restricted securities' were highly prescriptive and so the only question was whether the shares fell within their scope. The court stressed that the first issue was whether the employees had been allocated cash or shares. It noted that the shares were 'real shares which functioned as such' and that employees were not entitled to a fixed amount on redemption of the shares. The court added that the shares qualified as 'restricted securities' as there was a real possibility of the 'transfer, reversion or forfeiture' occurring. The fact that the circumstances of such occurrence had been inserted for tax avoidance purposes did not change the analysis. HMRC's appeal was dismissed.

DB had subscribed for shares which were 'restricted securities' in Dark Blue, a Cayman Island company set up for this purpose by Investec. The shares were then allocated to DB employees.

The UT had held that Investec was effectively controlled by DB, so that the shares in Dark Blue were not 'restricted securities'. The Court of Appeal overturned the UT's decision on this point, finding that the fact that Investec had cooperated with DB for the implementation of the scheme did not mean that it was not independent from DB. The court also rejected contentions that the reduction in value of the shares on a 'forfeiture' event would be insignificant. DB's appeal was allowed.

Comments - The success of such schemes, which like the Mayes scheme ([2011] STC 1269) took advantage of a highly prescriptive set of rules, is what motivated the adoption of the GAAR.

DB Group Services v HMRC (A3/2013/0207)

Relief for loan interest **(Lecture P832 – 8.44 minutes)**

Loan to buy shares in close company

Ss392 and 393 ITA 2007 allow borrowers to obtain income tax relief for interest on loans to buy ordinary shares in a close company which is not a close investment company. Relief is also available where a close company shareholder borrows funds and then lends the money to the company. In all these circumstances, care needs to be taken that the interest on such loans is not caught by the cap on otherwise unlimited income tax reliefs imposed by FA 2013.

For interest paid in 2014/15 and subsequent tax years, the definition of a close company has been changed in order to ensure compatibility with EU law. The term now includes a company which is resident in another EEA state but which would be a close company were it resident in the UK (ie. because it is controlled by five or fewer shareholders or by any number of shareholder directors).

In addition, note that the definition of a close investment company in S34 CTA 2010 has been replaced on an identical basis by new S393A ITA 2007. This is because of the impending repeal of S34 CTA 2010 following the adoption of a single rate of company taxation for 1 April 2015 onwards.

Loan to buy shares in employee-controlled company

Ss396 and 397 ITA 2007 provide a similar relief where the loan relates to an employee-controlled company. S397(2)(a) ITA 2007 is widened, for payments made in 2014/15 and subsequent tax years, so that an income tax deduction is available for interest on loans to buy ordinary shares in an unquoted trading company which:

(i) is resident in the UK or another EEA state; and
(ii) is not resident outside the EEA.

Contributed by Robert Jamieson

Capital Taxes

Work of art is a wasting asset

The late Lord Howard of Henderskelfe owned a painting by Sir Joshua Reynolds which had been on display in Castle Howard since 1950. The castle was owned by Castle Howard Estate Ltd. Lord Howard died in 1984. His executors sold the painting in 2001 and claimed the gain from the disposal was exempt under TCGA 1992, s 45, on the basis it was a wasting asset.

HMRC refused the claim, saying the painting was not plant. The First-tier Tribunal dismissed the executors' appeal.

The Upper Tribunal overturned that decision. HMRC appealed.

Decision:

The Court of Appeal said that only items used in a trade, profession or vocation could constitute plant under s 44. However, nothing in that section justified the conclusion that the only person to benefit under the legislation was the one who had used the asset or the trader in whose business the plant was used. Indeed s 45(1) confirmed there was no such limitation. It focused on the asset disposed of, not the owner of the asset. The exemption applied not only to a disposal of the asset but also to the disposal of an interest in it.

The Upper Tribunal had not erred in law by concluding that the company (that owned the castle) had a sufficient interest in the picture for it to qualify as plant.

On HMRC's point that an "old master", such as the painting, could not be a wasting asset, the judge said the asset, having qualified as plant, "was 'in every case' deemed by s 44(1)(c) to be a wasting asset; and for HMRC to argue that an item of plant enjoying unusual longevity is not plant at all is to advance an argument that the section expressly excludes and which amounts to no more than a pointless beating of the air". He added that the provision "may have proved inconvenient to HMRC", but they must "take the rough with the smooth; and this case may be an example of the rough".

HMRC's appeal was dismissed.

Comments - This was an unusual case, in that a wasting asset used in a business was not sold by the trader. In confirming that the identity of the vendor is irrelevant to the application of the exemption, the case may constitute a useful precedent in many similar situations.

HMRC v The executors of Lord Howard of Henderskelfe (A3/2013/1568)

Implementing a CGT charge on non-UK residents (Lecture P831 –18.13 minutes)

The consultation document on the extension of CGT to UK residential property owned by non-UK residents was published on 28 March 2014.

In his Foreword, the Exchequer Secretary to the Treasury sets the scene:

'The Government do not believe that it is right that UK residents pay CGT when they sell a home that is not their primary residence, while non-UK residents do not. Similarly, we do not believe that it is right that UK companies are subject to tax that they make from disposals of residential property, whereas non-UK residents are not. It is important for the integrity of our tax system that, when gains are made from UK residential property, UK tax is paid.

This consultation document outlines the proposed design for the extension of CGT to address the current imbalance between the treatment of UK and non-UK residents disposing of UK residential property. This measure will bring the UK into line with many other countries that already charge CGT on the basis of the location of the residential property rather than the location of the seller.'

At this stage, the document only provides some general guidelines, although its main theme is clear: to put non-UK residents in exactly the same tax position as someone who is resident in the UK when it comes to dealing with disposals of UK residential property.

The main features of the Government's proposals can be summarised as follows:

- The charge will only apply to gains arising from April 2015 onwards.
- Non-UK resident companies and trusts will be liable to the charge as well as non-UK resident individuals.
- Partnerships owning residential property are not to be included because the CGT transparency rules will place the charge on the partners themselves.
- The charge will cover all UK residential properties (including those worth £500,000 or less).
- The CGT will be collected through a withholding tax arrangement.
- The rate of tax would appear to mirror the rules for UK residents, ie. if the non-UK resident's UK income is less than the basic rate band, tax will initially be charged at 18%. Otherwise it will be 28%.
- The annual CGT exemption will be available to non-UK resident individuals.
- The charge will not be imposed on any property which qualifies as the taxpayer's only or main residence.

There is an interesting overlap with the ATED-related CGT provisions which already apply to properties held by companies. The ATED-related CGT charge does not catch residential property which is commercially let or which is being developed. However, there will be no equivalent relief in connection with the new charge.

There is one unfortunate aspect of the consultative document which may affect UK residents. The Government are thinking about changing the principal private residence relief regime which deals with the election under S222(5) TCGA 1992. Two possible approaches are under consideration:

1. The removal of the ability for a taxpayer with two or more residences to decide which property is to be regarded as his main residence for CGT purposes; and

2. The replacement of the S222(5) TCGA 1992 election with a fixed rule which specifically identifies the taxpayer's main residence, ie. that in which he has spent the most time during the tax year.

If the first option is adopted, HMRC would then follow their existing practice when someone with two or more residences has not made an election. This typically involves the individual's main residence being determined by weighing up all the available evidence such as where his spouse and family live, where his mail is sent and the address which he uses for electoral purposes. The second option would appear to be a purely arithmetic one.

Finally, take pity on a UK resident with an offshore company which in future sells a residential property at a profit after many years of ownership. The gain up to 5 April 2008 will probably not be taxable as long as the individual is a non-UK domiciliary, but the gain from 6 April 2008 to 5 April 2013 will be chargeable on him personally under S13 TCGA 1992. The gain from 6 April 2013 to 5 April 2015 will be taxable on the company under the ATED-related rules and the gain from 6 April 2015 onwards will be subject to the new CGT charge. Or possibly not! Is it really meant to be as complicated as this?

Contributed by Robert Jamieson

Entrepreneurs' relief: was the vendor an employee?

The taxpayer successfully appealed against HMRC's decision to deny entrepreneurs' relief in respect of CGT on a disposal of shares in a company.

Mrs Corbett had been an employee of the company, as secretary to her husband who was the director. During the negotiations for the sale of the company, it became clear that the purchaser was not comfortable with the employment of spouses and so Mr Corbett removed his wife from the payroll. She continued her duties until the sale and Mr Corbett increased his own salary by the equivalent of his wife's salary. She ceased working for the company following the sale.

Under TCGA 1992 s 169I, entrepreneurs' relief on the disposal of shares is only available if the vendor is an officer or employee of the company. The issue was therefore whether Mrs Corbett had continued to be an employee of the company up to the time of the sale, despite her removal from the payroll.

Decision:

The FTT found that Mrs Corbett had continued to be an employee of the company and entrepreneurs' relief was available on the disposal of her shares.

Comments - HMRC's position was somewhat surprising, given the fact that the taxpayer had clearly continued to perform her duties as an employee of the company. However, this case is refreshing in that, for once, it was the taxpayer who was arguing employment.

Susan Corbett v HMRC TC3435

Entrepreneurs' relief and the cessation of a business **(Lecture P833 – 18.15 minutes)**

In Rice v HMRC (2014), the First-Tier Tribunal was asked to examine the question of whether a significant change in the taxpayer's business constituted the cessation of one trade and the commencement of a new one. If so, the taxpayer would be able to claim entrepreneurs' relief in respect of a chargeable gain arising on the disposal of a property used in his original business. On the other hand, if the Tribunal ruled that there had been no cessation, this valuable CGT relief would be denied.

The taxpayer (R) was a sole trader in the used car business. He owned premises on one of the main arterial roads going into Peterborough and traded under the name 'Performance Cars'. R depended on passing traffic for much of his trade. In other words, R's customers would typically stop as they were driving by and have a look at his current stock of sports cars which were available for inspection there and then on the premises.

Unfortunately, because the site was not as secure as it might have been, R found that he was suffering from vandalism to an increasing extent. Eventually, the problem became so bad that he had no option but to dispose of the premises. This he did on 29 April 2008, with contract and completion taking place simultaneously. The site was sold to a property developer.

However, R's trade had ceased quite some time before this date. His recollection was that this had taken place in May 2005. The stock of sports cars was sold at auction and through newspaper advertisements and evidence from Peterborough City Council showed that the premises had qualified for Empty Property Rates Relief with effect from 1 September 2005. The date when R ceased to trade was what was in dispute with HMRC – indeed, they asserted that there had not even been a cessation.

The reason for HMRC's line of argument was that R then started to sell used cars once more, but this time from a site adjoining his house in a village outside Peterborough. He renamed the business 'Four

Acres Car Sales' after the name of the house. The original intention was that the new business should be run in much the same way as the old one had been, but this was thwarted by R's local council who initially banned him from trading from the property. In due course, R persuaded them to give him planning permission to sell cars, but there was a caveat that there could be no display of vehicles for sale to the general public. As a result, R had to change tack and started to conduct his business by advertising on the internet. Potential customers had to make an appointment to come to his house to inspect a particular vehicle. This revised arrangement started on 29 September 2006.

At 'Four Acres Car Sales', there was no forecourt displaying cars to the public. There was a small sign showing the business name, but, unlike 'Performance Cars', there was no passing trade. And R was selling a different type of car – in this latest venture, he was concentrating on four-wheel drive vehicles and family cars.

When the original premises in Peterborough were sold, R found that he had made a capital gain of nearly £275,000 in respect of which he claimed entrepreneurs' relief for 2008/09 under S169I(2)(b) TCGA 1992. This required him to have carried on the business for at least 12 months up to the date of his cessation and for the premises to have been sold within a three-year period following that cessation. That is to say, R's cessation of trade had to have taken place after 29 April 2005.

After the submission of R's 2008/09 tax return, HMRC opened an enquiry into the entrepreneurs' relief claim. In a letter dated 15 August 2011, they wrote to R saying that his business had 'relocated to the grounds of (his) private residence from where trading continued more or less as before'. In other words, HMRC denied that there had been a cessation.

At the hearing, R's accountant relied on concepts drawn from authorities on the cessation of trade:

- Fry v Burma Corporation Ltd (1930);
- JG Ingram & Son Ltd v Callaghan (1968); and
- Rolls Royce Motors Ltd v Bamford (1976).

In particular, the Burma Corporation case established the principle that the relocation of a local business could give rise to a permanent discontinuance of one trade and the commencement of a different one. It was submitted on behalf of R that the changes made in his mode of business were 'sufficient and substantial enough' to fall within that principle.

The JG Ingram and Rolls Royce cases both referred to the concepts of 'organic unity' and 'organic growth' within a business. R's accountant argued that there was a difference between a slow and gradual change (ie. one which was 'organic') and a sudden and dramatic change. It was contended that the changes to R's business fell into the latter category.

The First-Tier Tribunal accepted R's evidence that, with the original 'Performance Cars' business, most of his sales came from passing customers who would stop to look around his forecourt. They considered that the change to an internet business with no passing trade and with customers coming to a country village because they had seen R's website constituted a very significant change in the way in which his business activities were conducted. There had therefore been a cessation of trade. The Tribunal also accepted that this cessation took place within the requisite three-year period.

The case provides helpful guidance about the degree of change which is necessary in order to establish that there has been a discontinuance. It will be of interest to entrepreneurs who are contemplating a shift of emphasis in their business operations and the disposal of assets as part of that process.

Contributed by Robert Jamieson

IHT and property management companies (Lecture P834 – 16.03 minutes)

The First-Tier Tribunal recently held that, on the facts, the management of a trading estate was predominantly an investment activity which disqualified the business from being eligible for business property relief (Best v HMRC (2014)).

The facts were as follows. On the death of Mr Buller in December 2007, his personal representatives prepared an IHT return on the basis that his holding of 25,000 shares in Bullick Developments (1986) Ltd (an unquoted family company) qualified for business property relief.

The company owned an eight-acre plot of land north of Belfast and a disused factory now converted into a trading estate with units which were rented out for office and light industrial use. As well as letting the land, the company managed the site and provided the following tenant facilities:

- electricity, water and telephone;
- postal and fax services;
- stationery supplies;
- free parking;
- 24-hour access;
- 24-hour security with a full-time security guard manning the barrier;
- boardroom hire;
- provision of a receptionist;
- secretarial and photocopying services;
- a full-time site manager (initially Mr Buller); and
- a forklift truck and the use of a full-time driver.

HMRC denied the availability of business property relief on the ground that, although some of the services were the sort which might normally be expected to be supplied by a landlord (eg. heat and light, telephone and parking), the additional services such as the provision of a full-time site administrator, a receptionist who operated the switchboard, secretarial services, a boardroom for hire and a forklift truck and driver were insufficient, in their opinion, to tip the balance in favour of a predominantly non-investment business.

It should be remembered that a company will be excluded from the business property relief regime by virtue of S105(3) IHTA 1984 if:

'. . . the business carried on by the company consists wholly or mainly of one or more of the following, that is to say, dealing in securities, stocks or shares, land or buildings or making or holding investments.'

The First-Tier Tribunal, following the reasoning in George v CIR (2004) and applying the 'hypothetical intelligent businessman test' developed in a number of IHT cases since it was first used in Weston v CIR (2000), decided that the company's business was mainly one of investment. Crucial to that test was the question of how important any non-investment activities were to the business as a whole. The provision of electricity, water and telephone were accounted for within the tenants' service charges and therefore fell on the investment side of the fence. The other additional services, which could be described as over and above what might normally be provided by a landlord and which were separately charged for, were not sufficiently substantial to allow the company's business to be classified as predominantly non-investment.

Although this case was decided on its particular facts, practitioners may find it instructive to compare the activities in Best with those conducted by their own clients when advising on the applicability of business property relief. One of the Tribunal judges suggested that it might have been possible to characterise a self-contained part of the site which was let out to a long-standing tenant referred to as Burdens and which gave rise to approximately 15% of the company's turnover as a separate investment part of a composite business (ie. an excepted asset under S112 IHTA 1984). It might therefore be argued that the 'wholly or mainly' criterion should then be applied to the remaining estate which, in some cases, could produce a different outcome.

One final observation is that, unlike the CGT case of Ramsay v HMRC (2013) where the question was whether or not the taxpayer was carrying on a business, in Best the Tribunal judges appear to have accepted that the company was indeed conducting a business. The key aspect here was: is it wholly or mainly a trading business?

Contributed by Robert Jamieson

Gift with reservation (GWR) – the Buzzoni case (Lecture P835 – 8.41 minutes)

On 19 December 2013, the Court of Appeal gave judgment in the IHT case of Buzzoni v HMRC (2013), overturning the earlier decisions of both the First-Tier Tribunal and the Upper Tribunal. Their ruling was that a leasehold flat given by a mother to her two sons was not a GWR, despite the fact that the underlease contained 'good repair' clauses in her favour.

The taxpayer (Mrs K) acquired a lease of just under 100 years to a flat in London in return for a premium of £250,000. 17 months later in November 1997, Mrs K created a settlement for her two sons and granted the trustees an underlease to the flat for their benefit for the remainder of the headlease term. Like the headlease, the underlease imposed covenants on the leaseholders to pay the ground rent and service charges and to keep the flat in good condition.

Mrs K died in 2008. Her personal representatives expected the gift of the underlease to be treated as potentially exempt, given the passage of time which had elapsed since the original transfer.

However, HMRC saw the position differently. They claimed that the gift was in fact a GWR under S102(2) FA 1986. Their main assertion was that the property in question was not enjoyed to the entire exclusion of any benefit to the donor. The donor, they argued, had retained a benefit in the form of the flat's guaranteed good condition when it reverted to Mrs K's estate at the end of the underlease term.

Similar matters have been considered in previous cases, most notably as part of the House of Lords' decision in Ingram v CIR (1999).

HMRC's arguments persuaded both the First-Tier Tribunal and the Upper Tribunal to agree that the property transfer was indeed a GWR. However, at the Court of Appeal, judgment was unanimously given in favour of Mrs K's personal representatives. Essentially, the three Court of Appeal judges held that the benefit, which Mrs K was said by HMRC to have retained, had already been consumed by her own landlord (ie. the company which had sold her the headlease with its 'good repair' covenants). As Moses LJ pointed out:

'The imposition of duplicate obligations on that property merely mirrored but did not add to the obligations which the underlease already bore under the licence to underlet.'

It is not known whether HMRC will try and take this case further.

Contributed by Robert Jamieson

Administration

Lifestyle not substantiated by income

Mr Whittle appealed against HMRC assessments which had been issued on the basis that his income, together with his wife's, was insufficient to substantiate their lifestyle.

Mr Whittle was a taxi driver. During the enquiry, HMRC reviewed his expenditure extensively and concluded that a shortfall of £7,452 existed. This was on the basis that costs had been underestimated, in particular, household and holiday costs.

Decision:

The tribunal, in turn, reviewed the expenses of the couple and noted that their household was not a typical average family of two adults and two children. In the relevant tax year, only one daughter was at school. The other was in employment and contributed to the household budget. Furthermore, Mrs Whittle was in employment with a travel agent with unusual terms and conditions. She was absent from home for lengthy periods of time and received an allowance for this, while her flights were discounted. The running costs of the couple's house were unusually low as it was eco-friendly and was less occupied than the norm, as a result of Mrs Whittle's employment. The tribunal concluded that the declaration of income and the account of personal expenditure by Mr Whittle were correct - appeal was allowed.

Comments - The taxpayers clearly excelled at managing their expenses effectively which made them suspicious in the eyes of HMRC — in the absence of precise reliable records of their income. Taxpayers in similar situations should therefore ensure that they can substantiate a claim that their income is sufficient to cover their expenses.

Glen Whittle v HMRC TC3393

Right of defaulters to remain anonymous

The FTT held that the taxpayers were not entitled to prevent the publication of their names as deliberate defaulters.

Mr and Mrs B had been negotiating with HMRC in relation to the imposition of a penalty for deliberate inaccuracy, and they had tried to ensure that their names would not be published. Although the tribunal accepted the taxpayers' evidence that the matter of publication of their names was at the 'forefront of their minds' when they accepted HMRC's offer of settlement, the tribunal found that this was not apparent from their letter to HMRC. The tribunal therefore concluded that a valid contract on the objective terms set out in the review letter was reached.

The taxpayers were appealing out of time and the tribunal suspected that the only reason for the appeal was that the taxpayers wished to prevent the publication of their names as deliberate defaulters.

Decision:

The tribunal accepted that this was a serious matter for Mr B, as liability to a civil evasion penalty could affect his livelihood as a solicitor since it could lead the Solicitors Regulatory Authority to strike him off. However, the tribunal also noted that the taxpayer had been prepared to acknowledge his default, provided that his name was not published. The tribunal decided not to allow the appeal out of time.

Finally, the tribunal recognised that its decision could be appealed and so it decided to anonymise it until the appeal process was exhausted.

Comments - The key issue for the taxpayer was its reputation on which his livelihood depended. The tribunal recognised this but also felt that the public has an interest in knowing that a solicitor has been found liable to a deliberate inaccuracy penalty.

Mr and Mrs B v HMRC TC3395

Was compound interest payable by HMRC on VAT wrongfully levied?

Littlewoods successfully sought to recover compound interest (representing approximately £1.2bn) on VAT paid between 1973 and 2004. HMRC had already refunded the principal VAT amount (together with simple interest) which had been wrongly paid in relation to commissions paid to agents who placed orders in the Littlewoods catalogue. Interestingly, following the Grattan decision (C-310/11), HMRC now claimed that VAT had actually been due.

Decision:

The court exhaustively reviewed (and quoted) the proceedings up to then, as well as the Grattan decision (which turned on similar facts), and rejected HMRC's argument that its case was supported by Grattan. However, Justice Henderson also noted that he was inclined to find in favour of HMRC in relation to the underlying VAT issue.

Furthermore, HMRC was not estopped from raising the issue of liability to VAT. The Caffoor principle — although anomalous — had been applied by the UK courts to tax cases and could apply to VAT (with suitable modifications). The CJEU had consistently held that 'the principle of legal certainty is trumped by the principle of effectiveness'. However, it would be an abuse of process to allow HMRC to defend the claim to compound interest on this basis.

In relation to interest, the court emphasised 'the crucial point that the right to interest on tax levied contrary to EU law has now been unambiguously recognised by the [CJEU]' (not only in this case but also in British Sugar (C-147/10) and Irimie (C-565/11)) as a right conferred by EU law which ranks equally with the right to repayment of the unlawfully levied tax. The court concluded that 'the concept of an adequate indemnity must mean an indemnity (or compensation) which is at least broadly commensurate with the loss of the use value of the overpaid money in the hands of the taxpayer'. It added that the CJEU had not specifically referred to compound interest in the Littlewoods case because Littlewoods had not put its case in such terms and questions of interest are normally left to the national

courts. The court also noted that the CJEU's decision must be applicable across the EU and that simple interest is often an adequate remedy.

Additionally, the court found that VATA 1994 s 78 and s 80 could not be construed so as to conform with EU law and must therefore be disapplied so as to allow the claimants to pursue both their Woolwich claims and their mistake-based claims.

Finally, in relation to quantum, the benefit to the government from the overpayment of VAT was, as a matter of law, 'correctly measured by the objective use value of the money, which translated into an award of compound interest' without the need to refer to the actual benefit derived by the government from the use of the money. Any additional corporation tax which the claimants would have had to pay if the VAT payments had not been made should be ignored for this purpose.

Comments - At the outset of the case, Justice Henderson noted that following: the CJEU's ruling in the case, 'both sides found themselves able to claim, with at least superficial plausibility, that their case had been substantially vindicated'. Fortunately, his exhaustive decision (which runs to 449 paragraphs) brings much needed clarity to issues which have preoccupied VAT practitioners for over a decade.

Littlewoods v HMRC (HC08C03780)

Some costs allowed

In January 2012 HMRC issued estimated assessments on a farming partnership for the years 1989/90 to 2007/08. They also imposed penalties. The partnership appealed.

Three days before the scheduled hearing of the appeal, HMRC withdrew the assessments and penalties. The partnership applied for costs.

Decision:

The First-tier Tribunal said HMRC had not acted unreasonably. They had rather taken “a pragmatic decision not to defend the appeal in a similar manner to an appellant who, after receiving advice from counsel, may decide to withdraw an appeal for commercial considerations”.

However, the judge decided that HMRC had not complied with directions issued by the tribunal, and this had led to the partnership's accountants having to undertake additional work. HMRC were ordered to pay the partnership's costs that arose as a result of this failure. The taxpayer's application was allowed in part.

Comments – Unfortunately it is very difficult to get a finding at the Tribunal that HMRC have acted wholly unreasonably. However in this case because they had not followed the requisite rules they were ordered to pay the partnership's costs that arose as a result of this failure – So a partial victory was achieved.

JH and IM Ward (and related appeals) TC3248

Illness is an excuse

The taxpayer submitted her 2009/10 tax return on 27 January 2011. She had a balancing payment of tax of £58,600 to make, but did not pay the amount until 7 March. HMRC issued a surcharge on the late paid tax.

She claimed reasonable excuse. She had undergone major surgery in autumn 2010, had suffered complications and would undergo chemotherapy later in 2011. As a result she had not been well enough to deal with her affairs properly and had been unable to sort out the funds to pay the January tax bill.

Decision:

The First-tier Tribunal agreed that the taxpayer's illness constituted reasonable excuse throughout the default period. An investment she had made in January was a contributory factor, but not the main reason for the delayed payment.

The taxpayer's appeal was allowed.

Comments – This is a classic example where a penalty has been raised through the system without any thought process and the Tribunal has exercised judgement and compassion in the circumstances.

J Woolf v HMRC TC3165

Post is reliable

The taxpayer company had two director-shareholders (a father and son) who worked full time, and two other shareholders, one of whom was retired and the other worked part time. In April 2010, the father fell ill, so his son had to run the business. This led to some PAYE monthly payments being made late.

HMRC accepted that the son had a reasonable excuse for the late payments for May, June and July 2010 (months one to three), but said he should have put adjustments in place thereafter to ensure payments were made on time. They imposed penalties under FA 2009, Sch 56 for the late payments for months four to ten. The taxpayer appealed.

The son explained that the cheque for each monthly PAYE amount was posted first class to HMRC at least one day before the sum was due. For example, months four and eight were posted on 16th of the month, months five and ten on the 17th and months six, seven and nine on the 18th. He did not obtain proof of posting because the letters were part of a bundle.

Decision:

The First-tier Tribunal did not consider it relevant that the son had not obtained proof of posting, and accepted his assertion that the cheques were posted on the days stated. The tribunal noted that the Post Office aims to deliver 93% of first-class post by the next day, and said it would "be a rare event for a properly addressed first class letter to take more than two working days" to arrive at its destination. Yet

HMRC said that it had taken the correctly addressed, pre-franked, first-class envelopes four days to arrive in three cases, five days in one instance and six days in three others. The tribunal commented that no evidence was produced to support the department's claims that the postal service was “as unreliable as these figures would appear to demonstrate”. Instead, the judge said, because HMRC were likely to be “inundated with PAYE payments” around the 19th of each month, they were unlikely to deal with all the post on the day it arrived.

The tribunal concluded that the date HMRC logged the cheques on their computer system was not a reliable reflection of the date the department received them. The judge said: “first-class post is ordinarily delivered the day after posting” and HMRC had not proved that the cheques had arrived late.

The taxpayer's appeal was allowed.

The judge did not stop there. On the issue of fairness, over which, as a result of the decision in Hok Ltd, the tribunal has no jurisdiction, she said in relation to HMRC's not notifying the taxpayer that penalties for late payment were accumulating:

“We are very concerned by HMRC's failure to issue warnings as the penalties accumulate. The PAYE penalties under Sch 56 are calculated based on the number of defaults and the amount of tax paid late. By being based in part on the number of defaults, parliament clearly intended to incentivise taxpayers to minimise their defaults. Yet a taxpayer cannot minimise its defaults if it does not know it is in default.”

The judge thought HMRC should notify taxpayers whenever a payment was late, saying it could not be fair to allow a taxpayer “to rack up penalties of £24,000 for nine alleged late payments without any warnings”.

Comments – The decision and the comments by the judge are self-explanatory and worth noting. One aspect of this case comes up in Tribunals again and again which the inability of the Revenue to confirm the date of receipt and therefore their reliance on the date of logging. Until this is addressed by the requisite procedures we will see this occurring in future Tribunals – Definitely a case of déjà vu to come - watch this space

Kestrel Guards Ltd v HMRC TC3324

Business Taxation

Deductibility of management expenses

The partially successful appeal concerned the deductibility of management expenses incurred by HJ in respect of rental guarantees given over leases of retail spaces entered into by its subsidiary, MFI Properties.

In order to obtain prime out of town sites, MFI had needed parental guarantees. HJ had subsequently been called upon to make payments under the guarantees, following the sale of MFI to another group of companies. It was agreed that HJ carried on investment business and that therefore the guaranteed payments would only be deductible if they constituted management expenses (ICTA 1988 s 75).

Decision:

The FTT accepted that the giving of the guarantees (and the making of rental payments under the guarantees) had a dual purpose: to allow MFI to access prime retail sites; and to give HJ a stronger dividend return. This duality of purpose was not fatal to the deductibility of management expenses, particularly since such duality is common for holding companies. However, this expenditure was essentially on the assets held by HJ (supporting the value of the shares in MFI), rather than on the investment business of HJ itself. Therefore, it fell 'on the wrong side of the line of deductible management expenses'. The position was different for the release payments. These should be treated as management expenses, as they were made as part of HJ's cost management strategy. The appeal was therefore allowed only in respect of the release payments. It was dismissed in relation to the guaranteed rental payments.

Comments - The deductibility of management expenses has already given rise to a plethora of case law which this decision helpfully summarises. It also clarifies the distinction between asset management expenses and business management expenses.

Howden Joinery Group v HMRC TC3396

Consortium relief: non-UK link company

Hutchison Whampoa Ltd (the ultimate parent company) was a company having its seat in Hong Kong. The applicant companies had their seats in the United Kingdom. As indirect subsidiaries at least 75% owned by the ultimate parent company, they were members of a group for the purposes of s 413(3)(a) of the Income and Corporation Taxes Act 1988. Hutchison 3G UK Ltd (the loss-surrendering company) was also a company having its seat in the UK. It was owned indirectly by a consortium and constituted, on that basis, a consortium company within the meaning of s 406(1)(b) of the Act. That consortium included Hutchison 3G UK Investment Sàrl (the link company), a company having its seat in Luxembourg. Being a member of both the group and the consortium that were referred to above, it was a link company within the meaning of s 406(1)(a) of the Act. In other words, it was through that company that the applicant companies were connected, for the purposes of the UK tax legislation relating to consortium group relief, to the loss-surrendering company. The link company was wholly owned by

another company, Hutchison Europe Telecommunications Sàrl, which had its seat in Luxembourg. Hutchison Europe Telecommunications Sàrl itself was owned indirectly by the ultimate parent company, through various companies some of which had their seat in third states. The loss-surrendering company, whose objects were the establishment and operation of a mobile telephone network, made substantial investments which had been recorded in its trading account between 2002 and 2005. Under ss 402 to 413 of the Act, the losses which resulted from that activity could be set against the taxable profits of other resident companies that were members of the group or of the consortium. The applicant companies, which had made a profit in the same tax years, sought to take advantage of that possibility and, to that end, claimed consortium group relief on the basis of ss 402(3) and 406 of the Act from the UK tax authorities. Their claims were rejected on the ground that the link company was neither resident in the UK for tax purposes nor carried on a trade there through a permanent establishment. That ground was challenged before the First-tier Tribunal (Tax Chamber) UK (the referring tribunal), which decided to stay the proceedings and to refer certain questions to the Court of Justice of the European Union (the Court) for a preliminary ruling.

By its questions, which it was appropriate to examine together, the referring tribunal asked, in essence, whether arts 49 TFEU and 54 TFEU should be interpreted as precluding legislation of a member state under which it was possible for a resident company that was a member of a group to have transferred to it losses sustained by another resident company which belonged to a consortium where a "link company" which was a member of both the group and the consortium was also resident in that member state, irrespective of the residence of the companies which held, themselves or by means of intermediate companies, the capital of the link company and of the other companies concerned by the transfer of losses, whereas that legislation ruled out such a possibility where the link company was established in another member state.

Decision:

Freedom of establishment, which art 49 TFEU granted to European Union nationals, included the right for them to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the member state where such establishment was effected. It entailed, in accordance with art 54 TFEU, for companies or firms formed in accordance with the law of a member state and having their registered office, central administration or principal place of business within the EU, the right to exercise their activity in the member state concerned through a subsidiary, a branch or an agency.

Articles 49 TFEU and 54 TFEU should be interpreted as precluding legislation of a member state under which it was possible for a resident company that was a member of a group to have transferred to it losses sustained by another resident company which belonged to a consortium where a "link company" which was a member of both the group and the consortium was also resident in that member state, irrespective of the residence of the companies which held, themselves or by means of intermediate companies, the capital of the link company and of the other companies concerned by the transfer of losses, whereas that legislation ruled out such a possibility where the link company was established in another member state

Comments - This decision confirms not only that a link company does not need to be established in the UK for consortium relief to be available, but also that this is the case where the parent and intermediate companies are not established in the UK.

Felixstowe Dock and Railway Company v HMRC (C-80/12)

Close company—shares in close company payable in instalments

The appellant was at all material times a close company as defined in TA 1988 s 414. In 2000 the appellant and a potential US investor ("G") entered into an agreement ("the shareholders agreement") under which G agreed to subscribe for 4,808,880 "B ordinary shares" in the appellant and acquired voting control of it. The subscription price of £2,170,172 for the shares was payable by G in four instalments over a four-year-period, and those sums were included in the appellant's balance sheet in all relevant years under the heading "debtors". G did not make the payments. An issue arose as to whether in principle any liability to tax under TA 1988 s 419 had been incurred by the appellant in respect of the unpaid share capital. The appellant argued, inter alia, G's subscription for shares for payment in instalments did not give rise to a debt within the meaning of TA 1988 s 419; and an individual who subscribed for shares in a company as an incoming shareholder was not a "participator"—as defined in TA 1988 s 417(1)—in the company for the purposes of s 419 at the time at which he subscribed for the shares and incurred a liability to pay for them. HMRC submitted (a) s 419 included the definition of "loan" the case where a participator incurred a debt to the close company; and (b) where a subscription price became due and owing on entering into an agreement to subscribe for shares but the consideration was payable in instalments, the subscriber was a participator and incurred a debt within s 419(2).

Decision:

The purpose of TA 1988 s 419 was to impose a charge to tax where profits, assets or value were extracted from a company without a charge to tax (being usually a charge to tax on distributions or dividends). When a company issued shares it was not selling any existing intangible property or any new right over a fraction of its existing assets. It was increasing its assets by acquiring capital and acknowledging the new shareholder's rights as residual owners of a previously non-existent faction of the increased assets which they had contributed in the form of capital. In the present case there was no extraction of profits, assets or value. Securing control of a close company was not within the contextual or purposive meaning of incurring a "debt" under s 419. Nor could the accountancy treatment of the subscription price alter the legal effect of the share subscription agreement. TA 1988 s 419 and the term "debt" had to be construed in such a way so to exclude their application to a liability to make a payment which was incurred on a subscription for shares for a price payable in instalments. G's liability was to honour an investment promise. That was a share subscription, not a share purchase. Nothing in the terms relating to G's investment referred to "fully paid and called up". It was not a liability to repay moneys borrowed or owed. It was not a debt within the context of s 419.

Applying the definition of "participator" in TA 1988 s 417, G could not be described as a participator until he had subscribed for shares. Until that point in time he would not be "a person having a share or interest in the capital or income of the company" within the meaning of s 417. G incurred a liability upon

(but not prior to) the very act which made him a participator in the company. Taking into account the context and the terms of G's subscription, the loan did not constitute the sort of mischief at which s 419 was aimed which was the prevention of existing shareholders/participators extracting funds from a close company in otherwise non-taxable forms. A purposive construction of ss 417 and 419 reinforced that analysis. In the close company context, s 419 was not designed to penalise, discourage or distort investment in close companies and should not be construed so as to apply to the making of an investment. The appeal would be allowed.

Appeal allowed.

Comments – It is somewhat surprising that HMRC took this case as S419 or s455 is clearly directed at the circumstances set out above - The purpose of TA 1988 s 419 was to impose a charge to tax where profits, assets or value were extracted from a company without a charge to tax (being usually a charge to tax on distributions or dividends). However the case decision went the correct way.

RKW Ltd v Revenue and Customs Comrs TC 3289

Limitation to loss relief in relation to partnership share

Hamilton & Kinneil (HK) claimed loss relief in relation to losses made by an LLP of which it was a member, together with a Delaware incorporated LLC (which was an investment vehicle for US investors). The LLP was set up to develop and run a golf course.

HMRC had denied the claim on the basis that ICTA 1988 s 118ZC limited a claim for loss relief to the greater of the amount the member had contributed as capital or the amount he was liable to contribute in the event of a winding up.

Decision:

Although the FTT did not reach a unanimous decision, it held that the legislation was not ambiguous and so there was no reason to refer to extra-statutory material. Applying the legislation, the amount of HK's contribution was zero. This was because acquiring a share through the LLP agreement and maintaining it in the LLP was 'far removed' from contributing it to the LLP. However, under the LLP agreement, the amount HK was liable to contribute on a winding up was its one third share which therefore was the cap to a loss relief claim.

Comments - The case is a useful guide through the meanders of ICTA 1988 s 118ZC.

Hamilton & Kinneil v HMRC TC3485

Business not conducted on a commercial basis

Mr Murray claimed losses in relation to a race horse breeding and trading business, which totalled about £130,000 over a three-year period.

HMRC had denied the claim on the basis that the taxpayer did not carry a commercial activity with a reasonable expectation of profit (ITA 2007 s 66(2)).

Decision:

The tribunal considered that the taxpayer may have had a reasonable expectation of profit at the outset of his business, however that hope must have 'evaporated' when losses were realised in three consecutive tax years. Furthermore, there was no evidence that Mr Murray had attempted to quantify the losses or to reduce them by producing a business plan.

Finally, Mr Murray's comment that the viability of his horse breeding business depended upon his obtaining tax rebates on his other incomes confirmed that his view was not commercial.

Comments - In uncertain economic times, this case may be a warning to other loss making businesses. A hope that things will eventually get better may not be enough for trading losses to be allowable.

Richard Murray v HMRC TC3474

Finance Act 2012 pooling requirement **(Lecture B831 – 20.05 minutes)**

Introduction

Finance Act 2012 introduced new sections 187A and 187B of the Capital Allowances Act 2001 (CAA 2001). These created two obstacles that buyers of commercial property must navigate to claim plant and machinery capital allowances for fixtures.

Fixed Value Requirement/ Disposal Value Statement Requirement

The first is called the 'Fixed Value Requirement' (although there is a rarer alternative called the 'Disposal Value Statement Requirement'). The second is called the 'Pooling Requirement'.

The Fixed value Requirement applies in most normal property transactions after April 2012 where the seller (or an earlier owner since then) is required to account for disposal proceeds on sale, having previously pooled qualifying expenditure on plant or machinery fixtures for capital allowances purposes.

For the buyer to claim capital allowances, the Fixed Value Requirement obliges it to either:

Option 1 - Agree a CAA 2001 s 198 joint election (or its s 199 equivalent for leases) with the seller to establish the disposal value of the fixtures, or;

Option 2 - Prepare a CAA 2001 s 562 just and reasonable apportionment of the total purchase price (restricted by CAA 2001 s 185 to the seller's disposal value, if the seller's qualifying expenditure was lower than the apportionment) and then apply to the Tax Chamber of the First-tier Tribunal for a determination of the disposal value.

Failure to comply (where applicable) will be catastrophic for the buyer of a commercial property. Its capital allowances qualifying expenditure for the fixtures in question is deemed to be nil. All future owners' qualifying expenditure also cannot exceed nil. The outcome is a permanently blighted property with no capital allowances associating with those fixtures. This may damage the market price of affected properties.

Pooling Requirement

For property sales and purchases from 1 April 2014 (corporation tax) or 6 April 2014 (income tax) a further obstacle applies. This is called the Pooling Requirement (which is also commonly referred to as 'mandatory pooling').

The Pooling Requirement applies to transactions from those dates where the seller (or an earlier owner since then) *could* have claimed capital allowances on plant and machinery fixtures (irrespective of whether it actually did).

Before the buyer can claim plant and machinery allowances for fixtures, the seller is first required to pool the qualifying expenditure in its own tax return. This is based on the capital expenditure incurred by the seller to build, buy, or refurbish the property at an earlier time. Once the expenditure has been pooled by the seller then the Fixed Value Requirement applies.

Failing to comply with the Pooling Requirement also means that the buyer's qualifying expenditure for the fixtures in question is nil. Again, the outcome is a permanently blighted property with no capital allowances associating with those fixtures. This may damage the market price of affected properties.

The Pooling Requirement only applies where the seller (or an earlier owner since April 2014) was *entitled* to claim plant and machinery allowances for fixtures. Broadly, that means circumstances where the seller is an owner-occupier or investor, which is within the charge to tax.

It does not apply where the owner:

- was not subject to tax (for example, a charity, pension fund or local authority), or;
- was only entitled to claim capital allowances because it had contributed towards another person's expenditure (for example, a landlord paying towards a tenant's plant), or;
- would not have been entitled to claim because the fixture (or fixtures) in question would not have been treated as plant in its hands (for example, commonly 'pre-commencement integral features' - general electrical power and lighting, cold water and external solar shading)

If there are any fixtures upon which the seller was not entitled to claim, then the buyer's claim is calculated by means of a CAA 2001 s 562 apportionment. The buyer simply needs to pool the expenditure in its tax return. It is neither necessary, nor possible, to agree a s 198 election with the seller or to apply to the First-tier Tribunal in respect of those fixtures.

Procedure

The buyer first needs to establish whether the seller (or an earlier owner since April 2012) claimed capital allowances for fixtures. If a claim has been made then the Pooling Requirement is not relevant because the qualifying expenditure has already been pooled. The Fixed Value Requirement would normally apply.

If the seller (or an earlier owner since April 2014) did not claim then the buyer needs to establish whether the seller *could* have claimed. If the seller could have claimed then the buyer will need the seller to pool the qualifying expenditure in its own tax return. Upon sale the seller is required to account for disposal proceeds so all (or some) of that qualifying expenditure will transfer to the buyer.

Implications

The Pooling is Requirement likely to result in additional professional costs for property buyers. The buyer will generally require a specialist capital allowances valuation anyway. But the seller will also need to submit a tax return (or amended return) to pool the expenditure. The buyer will probably be expected to pay for this. It would be sensible for the parties to jointly instruct a capital allowances valuer. But it is possible that some sellers might prefer independent capital allowances advice (for example, in a 'watchdog' capacity).

In many cases, once a seller has been alerted to the fact that they have been holding a valuable tax asset they may seek to retain some or all of the allowances by negotiating a s 198 election at a low amount. So many buyers may end up 'sleepwalking' or being 'railroaded' into giving away allowances which should otherwise transfer to them by default.

When the seller pools the qualifying expenditure, this will be based on the expenditure that it incurred at an earlier time. In most cases this is likely to be (potentially much) lower than the actual expenditure being incurred by the buyer.

Example:

In 2005 a property is built. The plant and machinery fixtures cost £75,000. The owner does not claim capital allowances. In 2015 it sells the property. The property has increased in value such that at the time of sale a 'just and reasonable apportionment' to the fixtures for capital allowances purposes is £125,000. Before the Pooling Requirement was introduced the buyer would have been able to pool its actual qualifying expenditure of £125,000. After the introduction of the Pooling Requirement the seller is required to pool qualifying expenditure of £75,000 and the buyer's claim is limited to that much lower amount.

Co-operation from seller?

If the seller declines to pool its qualifying expenditure this is a major problem for the buyer. The First-tier Tribunal can only intervene to determine the amount *after* the expenditure has been pooled. If the seller will not pool the expenditure then the buyer's options are limited to, for example, declining to buy the property or offering more money to incentivise the seller. Therefore, it is essential that the Pooling Requirement is addressed and agreed at the time of the deal (whilst the buyer has some leverage). Attempting to deal with this after the transaction has been concluded is likely to be prohibitively expensive, if not impossible, to resolve.

Time Limit

The seller's qualifying expenditure must be pooled *"... in a chargeable period beginning on or before the day on which the past owner* [that is, the current seller] *ceases to be treated as the owner of the fixture* [that is, sells the fixture]*, or a first year allowance has been claimed in respect of that expenditure (or any part of it)"* [CAA 2001 s 187A(4)].

This means that the seller's expenditure may be pooled up to three years after the transaction completion date. However, once the qualifying expenditure has been pooled by the seller then the Fixed Value requirement applies. That has only a two year deadline from completion.

Example:

A company has a period ending 31 December 2015. On 12 January 2015 it sells a property. The latest period beginning before the date of sale is the period ending 31 December 2015 (although, it could pool the expenditure in an earlier open return). The deadline to pool the expenditure in the tax return for the period ending 31 December 2015 is 31 December 2017 (by amending the return for that year). But once pooled, the Fixed Value Requirement applies. The deadline for this is nearly one year earlier at 12 January 2017 (that is, two years from completion).

Characteristics of capital allowances claims

Under the Finance Act 2012 fixtures rules, a buyer's capital allowances claim could comprise several components:

- Expenditure on fixtures that the seller (or an earlier owner since April 2012) has already pooled. The Pooling requirement will not apply because the expenditure has already been pooled. The Fixed Value Requirement applies. The buyer needs either a s 198 election, or an apportionment (limited to the seller's disposal value) with an application to the First-tier Tribunal;
- Expenditure on fixtures that the seller *could* have pooled at April 2014 but did not. The Pooling Requirement applies (requiring the seller to pool its qualifying expenditure). Then the Fixed Value Requirement applies;
- Expenditure on fixtures that the seller was *not* entitled to claim upon (for example, 'pre-commencement integral features'). Neither the Pooling Requirement, nor Fixed Value Requirement applies. The buyer's claim is calculated by a s 562 'just and reasonable apportionment' of the total purchase price. The buyer pools the qualifying expenditure in its tax return in the normal way.

Observations

Over time the information demands upon buyers are likely to become more difficult. It may be advisable for property owners and their advisers to safely retain information about capital expenditure (for example, fixed asset registers) and capital allowances claims in the long-term as these may be needed many years later.

Nothing in the Finance Act 2012 fixtures rules affects the disposal value that the seller is required to bring into account. So a seller cannot avoid accounting for disposal proceeds by neglecting or refusing to assist the buyer in complying with the rules.

The potential implications of the new rules are huge. There could be many existing properties containing items which undoubtedly ought to qualify for capital allowances, but no allowances are ever given because an owner inadvertently neglects to comply with the new rules. The seller's qualifying expenditure will be clawed-back on sale in the normal way (meaning that the net allowances claimed by it are nil). But the buyer's, and any future owner's, qualifying expenditure is also nil. So the total allowances available over the life of those fixtures (which existed long before the Finance Act 2012 changes were introduced) will be nil.

These new rules are an additional area of risk for property owners and their professional advisers. To protect against this buyers of commercial properties may wish to consider seeking specialist capital allowances advice at as early as possible during the deal. Indeed, in circumstances where there is any doubt, the tax professional bodies' guidance within *Professional Conduct in Relation to Taxation* (issued in February 2014) requires that members should not undertake professional work which they are not competent to perform unless they obtain appropriate assistance from a suitably qualified professional. Furthermore, version 3.3 of the *Commercial Property Standard Enquiries* (form 'CPSE.1') used by conveyancing advisers now, for the first time, asks for the name and contact details of the seller's capital allowances adviser. To ensure 'equality of arms' it would be advisable for buyers to consult a specialist. This may well become the norm.

Contributed by Steven Bone

New UK GAAP from 1 January 2015 (Lecture B832 – 12.29 minutes)

FRS 102 'The Financial Reporting Standard' is mandatory for UK GAAP financial statements from 1 January 2015, unless the business is eligible to use FRSSE (i.e. it meets the 'small company' criteria in company law), or unless choose to use EU-endorsed IFRS instead (which are more complex).

Existing tax law (ITTOIA and CTA 2009) states that accounting profit is the starting point for calculating adjusted taxable profits of a business. The accounting profit is likely to be different under FRS 102 for many businesses.

Of course there will still be specific tax adjustments, such as entertainment, depreciation, capital allowances, pension contributions not paid in the period, etc.

If FRS 102 changes the reported profit this could have tax implications, but not if caused by an accounting item which is ignored for taxation purposes, such as depreciation. It is principally a timing issue as total profit would be same over the life of the business so if tax rates do not change the total tax payable over the business life will be the same.

On first time adoption of FRS 102, 'prior period restatements' will be needed in first financial statements where there have been changes in accounting policy required by FRS 102.

The business must adopt FRS 102 from its 'transition date' which is the start of its comparative year, subject to certain exemptions to make transition easier.

If these adjustments to prior years' profits would have affected the tax payable in those years, a tax adjustment required. But in this case the adjustment is treated as a receipt or expense in the year of adoption.

So for example, if a company adopts FRS 102 in its year ended 31 December 2015, it will need to restate its 2014 profits and balance sheet and its balance sheet at 1 January 2014. Any adjustments to 2014 profits or retained earnings at 1 January 2014 which would have affected its taxable profits in those years, will be taxed or deducted in the tax computation for the year ended 31 December 2015.

Example

ABC Ltd adopts FRS 102 with effect from its year end 31 December 2015. Opening P&L reserves at the start of its comparative year (ignoring any tax effects) were as follows:

1 January 2014 – old UK GAAP	£480,000
1 January 2014 – FRS 102	£690,000
Increase in reserves	£210,000

The 2014 comparative year profits have been restated downwards by £45,000 due to an adjustment to lease incentives (covered in a later session).

Assume that the adjustments all have tax effects (at a 20% rate) which are recognised immediately.

Explain the current tax (and any deferred tax implications) of adopting FRS 102 on the 2014 and 2015 accounts.

Solution

There will be a current tax liability in the 2015 tax computation of 20% of (£210,000 - £45,000) i.e. £33,000

Dr Opening retained earnings	£33,000	
*Cr 2015 Current tax liability		£33,000

There is a question mark over whether deferred tax should be booked to cover the adjustment. The prevailing view is that deferred tax should be booked in the 2014 comparatives when presenting the 2015 financial statements

2014 deferred tax

Dr Opening retained earnings 1 Jan 14	£42,000		(20% x £210,000)
Cr Deferred tax expense 2014		£9,000	(20% x 9,000)
Cr Deferred tax liability 31 Dec 2014		£33,000	

In 2015, the deferred tax is reversed out

Dr Deferred tax liability	£33,000	
*Cr 2015 Deferred tax expense		£33,000

*This means than no net tax expense is recognised in the 2015 profit and loss account for the adjustments in 2015 (because the adjustments made to the tax computation are recognised in the financial statements of 2014).

Contributed by Malcolm Greenbaum

Tax implications of adopting FRS 102: Leases (Lecture B833 - 14.20 minutes)

Tax treatment of leases

The tax treatment generally follows the accounting treatment if using generally accepted accounting practice (such as SSAP 21).

Finance Act 2011 requires the 'old' treatment to be maintained for tax purposes if there is a change to lease accounting standards, but Para 53(3) says to use the new accounting method if it is equivalent to IFRS or SMEs. FRS 102 is equivalent and HMRC has confirmed that in its opinion, the tax treatment will continue to follow the accounting treatment on adoption of new UK GAAP.

Finance leases

The indicators of a finance lease is different in FRS 102 to that in current SSAP 21 which only has one principal indicator – whether the present value of the minimum lease payments is at least 90% of the fair value of asset at the start of the lease.

FRS 102 has more qualitative tests, including where the lease term covers major part of the asset's life. 'Major part' has been widely interpreted to mean in the region of 75% or more.

Because there are more indicators of a finance lease in FRS 102 there is more chance of finance lease treatment.

Example

MNO Ltd is adopting FRS 102 in 2015. It had entered into a 7 year lease for some lorries on 2 January 2013. The annual lease rentals are £124,000 payable annually in arrears (for simplicity) and the fair value of the lorries was £755,000.

The present value of the lease rentals has been calculated as £668,000 and the lorries are expected to have a life of 9 years. As the present value of the lease rentals is 88% of the fair value of the lorries the company has treated the lease as operating under SSAP 21 and has expensed £124,000 per annum in 2013 and 2014.

Your accounts team has noted that it will need to be reclassified as a finance lease under FRS 102 because the lease term is (7/9) 78% of the economic lives of the lorries and have provided the following calculations (which you can assume are correct).

		Asset	Liability
2013	Inception of lease	668,272	668,272
	Depreciation	- 95,467	
	Interest @ 7%		46,779
	Rental		-124,000
	at 31 December	572,805	591,051

2014	Depreciation	- 95,467	
	Interest @ 7%		41,374
	Rental		-124,000
	at 31 December	477,337	508,425
2015	Depreciation	- 95,467	
	Interest @ 7%		35,590
	Rental		-124,000
	at 31 December	381,870	420,014

Explain the adjustments required to the tax expense in the 2014 and 2015 accounts and the impact of the reclassification on the company's tax computations. Assume a tax rate of 20% throughout.

Solution

The company will need to show a lease asset of £572,805 and a liability of £591,051 in its transition date balance sheet at the start of the comparative year (2014) with a corresponding reduction in its accumulated profits of £18,246.

A deferred tax asset should be booked as at the start of 2014 of (20% x £18,246) £3,649 which should be shown as an adjustment to opening retained earnings at 1 January 2014.

The 2014 profit, restated for FRS 102 adoption needs to be increased by the rental expense previously charged of £124,000 and reduced by the depreciation and interest required by FRS 102 (£95,467 + £41,374) £136,841, a net reduction of £12,841. This will require an increase in the deferred tax asset of (20% x £12,841) £2,568 which will be shown as a reduction of the 2014 tax expense.

In the 2015 tax computation there will be a transitional adjustment to reflect the finance lease position at 31 December 2014, i.e. a deduction of £31,087, which represents the accumulated depreciation and interest (2 x £95,467 + £46,779 + £41,374) £279,087 and the amount claimed under SSAP 21 (2 x £124,000) £248,000.

This will result in a tax expense reduction in the P&L of £6,217 and the deferred tax asset is reversed out to net off against this.

There will be a normal tax deduction in 2015 for the depreciation and interest expense.

Operating lease incentives

SSAP 21 requires the benefit of a lease incentive to be spread over the period to the next rent review. FRS 102 requires spreading over entire lease term on a straight-line basis (unless another basis gives a fairer position).

On adoption of FRS 102, an entity can choose not to restate leases for lease incentives granted before the transition date (they would continue to be treated as before under SSAP 21). Any incentives given for leases commencing in the comparative year will need to be restated and this will have a tax effect in the year of adoption.

Example

DEF Ltd is adopting FRS 102 for the first time in its year ended 31 December 2015. It negotiated a 10-year lease on a warehouse on 1 July 2013, rent-free for 12 months followed by annual rentals at £150,000 p.a. The first rent review will be on 30 June 2017.

It negotiated a 15-year lease on its main operating premises on 2 January 2014. The lease was rent-free for two years, followed by annual rentals initially at £320,000 per annum. The first rent review falls due on 31 December 2018.

Explain the adjustments that may be required in DEF Ltd's accounts and tax computations in 2014 and 2015

Solution

The lease taken out in July 2013 does not need to be restated for FRS 102.

The lease taken out on 2 January 2014 must be restated as it is commences after the transition date of 1 January 2014.

The annual rent expense under old UK GAAP will be (£0 x 2 yrs + £320,000 x 3 yrs) ÷ 5 yrs = £192,000.

Under FRS 102 the annual expense is (£0 x 2 yrs + £320,000 x 13 yrs) ÷ 15 yrs = £277,333.

2014 accounts (restated)	
charged under UK GAAP	192,000
under FRS 102 would charge	277,333
Profit reduction required	85,333

2015 accounts:	
Same as 2014 so a further reduction of	85,333

<u>Current tax 2015:</u>

There will be a transitional deduction of £85,333 relating to 2014 which will be recognised in the 2015 tax computation giving rise to a tax reduction of (20% x £85,333) £17,067.

A deferred tax asset of £17,067 needs to be presented in the 2014 comparative figures when the 2015 financial statements are produced with a corresponding reduction in the 2014 tax expense shown in the profit and loss account, and this is then reversed out in 2015 when the real tax deduction is given.

Contributed by Malcolm Greenbaum

VAT

What is an e-service – getting ready for 2015 (Lecture B834 – 14.40 minutes)

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

- telecommunications services
- broadcasting services
- e-services

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

Example 1

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

<u>Practical issues concerning new rules</u>

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

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

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

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

Example 2

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

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

With effect from 1 January 2015, taxable sales in the UK will be £70,000 (assuming no change in trading factors etc) ie below the deregistration threshold because the French sales will be subject to French VAT.

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

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

Answer - October 2014 i.e. well in advance of 1 January 2015. The registration will not take effect until 1 January 2015 though.

Case study…..examples of 'e services'

Let me introduce you to Ana and Steve who operate two websites independently and are both based in the UK:

- Ana's website is of interest to dog owners and dog lovers. Basically if a dog owner is going on holiday and is looking for someone to look after his or her dog, then the website will give the owner access to a database of dog lovers who are prepared to do this task because they enjoy looking after dogs. The dog owners pay Ana an annual fee of £50 to subscribe to her website and get access to the complete database of dog lovers. Ana's total fees from the site are £50,000 a year and she has no other business income. She is not VAT registered because her total annual sales are less than the registration threshold (£79,000 until 31 March 2014)

- Steve's website is a dating site – where single people can list their profiles and photos on the site and meet other people for social or other purposes. The subscription for users is £50 per month and VIP members can pay an extra £50 per month for extra benefits e.g. they can include more photos on their profile and do better searches to find their ideal match. Steve is VAT registered in the UK as a sole trader because his total annual fees from the site are £250,000.

The above two scenarios are probably quite common in the modern digital economy i.e. using the web to make money. But are the businesses of Ana and Steve affected by the VAT changes taking effect on 1 January 2015 because they are providing an e-service?

HMRC guidelines – what is an e-service?

HMRC issued a Q&A paper on 12 July 2013, covering some of the main issues with the 2015 challenge and the answer to the question 'what is an e-service' is given with examples that I have shown below in Box 1 (I have also included examples of broadcasting and telecommunication services).

The problem with giving examples is that there is a danger that businesses might not think they are affected by the changes if their specific trading situation is not included in the list. HMRC's internal guidance (VATPOSS13550 – see below) gives a more detailed list about what constitutes an electronic service and includes within the list: "supply of images, text and information, and making databases available" – and also "services providing or supplying a business or personal presence on an electronic network such as a website or web page". In both cases, customers subscribing to the sites of Ana and Steve are paying for information, either about people who are prepared to look after dogs or people who are looking for friendship. And the sites are totally reliant on the web and electronic communications, another feature that is obviously appropriate in identifying what is an e-service.

Practical outcomes

The conclusion reached in the last section is that both Ana and Steve need to recognise the implications of the new rules that will take effect on 1 January 2015 and amend their business structures accordingly. In the case of Ana, she is likely to raise two arguments:

- She will probably say that she doesn't need to worry about VAT because her taxable sales are less than the VAT registration threshold (£79,000 until 31 March 2014)

- She has no idea where her customers live – when the dog owners enrol on her site, they only give their name and email address, and credit card/PayPal details but not their residential address. So she has no idea where they live, which could be anywhere in the world.

In the case of Steve, he might raise the same concern about not knowing the postal addresses of his clients, and therefore suggest that he carries on accounting for UK VAT at 20% on all of his sales ie to assume his customers are all UK based (although this argument might be difficult to support if, for example, he has customers in Dublin or other parts of Ireland on his site).

Taking the Ana situation, this is one of the key outcomes of the new regulations: for supplies made in another EU country, the registration threshold is effectively zero. So if Ana has one dog owner in Dublin or Paris paying her a subscription of £50, then she needs to deal with Irish and French VAT respectively. And her argument about not knowing where her customers are based is a practical challenge that she will need to deal with before 1 January 2015 – either by requesting more information from customers,

or possibly taking a strategic decision that the website will only be available for use by dog owners who live in the UK.

Steve's situation is more difficult: his business is more transparent for the tax authorities to know his geographical boundaries of trading and he is already in the VAT club by being registered in the UK. However, if Steve has been on top of his VAT game in the past, he will have identified by some means the customers on his site who are resident outside the EU eg America, because he does not need to account for UK VAT on these sales – they are outside the scope of VAT (VATA1994, Sch 4A, para 16(k).

Contributed by Neil Warren

When a UK business needs an overseas VAT number? (Lecture B835 – 14.26 minutes)

The above question becomes more important with the passing of time as the global economy continues to evolve with an increase in the volume of cross-border trading. In many situations, a UK business will not need to think about an overseas VAT registration e.g. if it is only selling goods to either VAT registered customers in other EU countries or exporting goods outside the EU. Most services will also avoid the need for an overseas VAT registration because of the general B2B (business to business) and B2C (business to consumer) rules we have had in place since 1 January 2010. However, here are some key situations where an overseas registration might be needed.

Distance selling

In the age of the global economy, it is very common for a business to sell its goods over the Internet. Let's imagine a UK business that sells mens shoes to a variety of customers throughout the UK and EU as a result of online orders, both to retailers and wholesalers, and also directly to private individuals. The good news is that any sales to customers outside the UK in another EU country will be zero-rated if the goods leave the UK and the customer is VAT registered in his own country. Our UK supplier will need to keep evidence of the goods being shipped to the other country, and also show the customer's VAT number on his sales invoice.

But what about sales to private individuals? Here are the key points:

- Each EU country can choose one of two annual distance selling thresholds – either 35,000 or 100,000 Euros. In general terms, the countries with the higher rates of VAT eg Denmark at 25% opt for the lower threshold.

- A UK business selling goods into an EU country must keep a record of all sales on a calendar year basis to customers in that country without a VAT number. Once the relevant distance selling threshold above has been exceeded on sales made since 1 January, the UK business stops charging UK VAT on its sales and obtains a VAT number in the customer's country. It will make sales based on that country's rate of VAT which applies to the goods in question and complete

VAT returns in that country. So the end result is that sales of shoes to private individuals in Denmark will be subject to Danish VAT of 25% rather than UK VAT of 20%.

I am often asked: How easy is it to get a VAT number in another EU country and deal with the VAT return and payment issues that follow? In honesty, it is an easier process in some countries compared to others, and issues such as language and interpretation of legislation can be a challenge in some cases.

Land services

The place of supply for a land service is where the land or building is located. And a business trading in an EU country other than its own does not get a VAT registration threshold ie a zero threshold applies. So if a UK based builder does some work on properties owned by private individuals in France, he will need a French VAT number and account for French VAT on his sales. See Example 1.

Reference: HMRC Notice 741A, section 6.

Example 1

Mary is an accountant in practice and not sure which of the following UK based clients need to become VAT registered in France:

- Tom is a decorator and has been asked to paint the house of a private person in France
- Dick is a solicitor and has been asked to do the conveyancing work for a property that his UK client is buying in France
- Harry is a property expert and is advising his UK client (private individual) about the best region in France to buy a property to obtain long term capital growth

Tom and Dick are both supplying land services in France and need a French VAT number. They must account for French VAT on their services. Harry is providing a consultancy service rather than a service that is directly related to any specific land or building so his services follow the general B2C rule ie he will charge UK VAT based on where he has his business.

Exhibitions, events and conferences

This is a confusing part of the VAT legislation and if you have any clients involved with organising exhibitions, conferences and events, then see HMRC VAT Notice 741A, section 8.

A key challenge for the EU legislators is to try and ensure that businesses in different countries trade on a level playing field, and one outcome of this strategy is that the VAT liability of admissions to events or conferences is based on where the event is held. See Example 2.

Note - the good news with the place of supply rules for admission fees is that any event held outside the EU avoids VAT – but be careful that there are not local taxes in that country that might need to be accounted for in the same way as VAT. For example, Australia has GST (Goods and Services Tax) and many other countries have similar taxes.

Example 2

John is VAT registered in the UK and is organising a conference in Spain on the benefits of a healthy lifestyle. He will charge an admission fee of £20 per delegate – the delegates will be a combination of business people and private individuals.

John must be VAT registered in Spain under the place of supply rules, and account for Spanish VAT on the admission fees. It is irrelevant that some of the customers are in business. The Spanish VAT registration will mean he can claim input tax on costs incurred in Spain (subject to the input tax rules in Spain, which are not necessarily the same as we have in the UK in relation to eg motor expenses, hotel accommodation, subsistence etc).

Note - many other sources of income linked to an event or conference will follow the general B2B and B2C rules. For example, if a German based pharmaceutical company sponsored the conference in Spain, then the place of supply would be Germany and the German company would deal with the VAT on its own return by doing the reverse charge calculation ie the place of supply is where the customer is based under the general B2B rule.

Other situations

- **Passenger transport services** – the place of supply is where the journey is performed – see HMRC Notice 741A, section 10

- **Catering** – The place of supply of restaurant and catering services is where the services are physically carried out. There is a separate rule for EC on-board restaurant and catering services – see HMRC Notice 741A, section 9

Final example - land related services

What happens if a UK builder is working in another EU country and his customer is VAT registered in that country. Does he need to get a VAT number in that country, or can the VAT instead be dealt with by the customer doing the reverse charge?

In the UK, our legislation extends the reverse charge to land related services to avoid having lots of overseas VAT registrations (HMRC Notice 741A, para 18.11). This means, for example, that a Polish based builder doing work on a UK property for a UK builder who is VAT registered will not need a UK VAT number. However, many countries require an overseas business making any land service to get a

VAT number and do not allow the reverse charge extension eg Italy. So the national legislation of each country needs to be checked on an individual basis to see whether a reverse charge outcome can be achieved.

Article by Neil Warren

Subsidy paid by a national fund to residential care homes

The CJEU held that the payment of a lump sum by the national sickness insurance fund to residential care homes for the elderly constituted consideration for the supply of care and was therefore subject to VAT. The lump sum was received as consideration for the care provided, which the homes were legally obliged to provide. The required link was therefore established and it was not broken by the fact that the consideration was provided by a person other than the recipient. This direct link existed regardless of the fact that the lump sum did not relate to a particular service provided at a particular time at the request of a resident.

Comments - The application of the VAT provisions to situations where the connection between the recipient and the provider of a service is slightly looser than usual always gives rise to difficulties. This decision is a useful reminder of the way the rules work in such circumstances.

Le Rayon d'Or v Ministre de l'Économie et des Finances (C-151/13)

Construction of a garage attached to a listed building

The FTT found that the provision of construction services for the building of a garage abutting a listed building was zero rated. The construction of the garage fell within the scope of VATA 1994 Sch 8 Group 6 item 2 as 'the supply, in the course of an approved alteration to a protected building, of any services other than the services of an architect…' HMRC's view, as set out in its guidance manual (VCONST08240), was that in the absence of substantial reconstruction of the house, the garage did not fall to be zero rated (as it did not fall within the scope of note 2 to Group 6).

Decision:

However, the tribunal explained that it was not necessary for note 2 to be satisfied, as the building of the garage had been made in the course of an approved alteration to an existing protected building which was to remain a dwelling after the alterations (note 1). HMRC had therefore erroneously concluded that any works involving a garage must meet the requirements of note 2.

Comments - The decision seems to be at odds with both HMRC guidance (as set out in its manual) and the VAT tribunal decision in Sherlock (VAT 18793 – 2004). However, it will only be of relevance to works carried out before 1 October 2012, as works to protected buildings carried out after that date are standard rated.

Ian Owen v HMRC TC3384

Fleming claim: amount recoverable

The NHS trust claimed VAT repayments under FA 2008 s 121 ('Fleming claims') relating to the supply of medicines and drugs.

Section 121 refers to the claims as ones 'for which the applicant held the required evidence'.

Decision:

The FTT considered that the use of the past tense reflected parliament's intention that the usual strict record keeping requirements were not applicable, as claims could go back well before the time for which traders are required to keep records. Only a 'reasonable degree of proof' was required. In order for the amount of a claim to be calculated, the difference between what was paid and what ought to have been paid must be worked out. The FTT endorsed the appellant's calculation method (with some minor adjustments) and gave the parties leave to seek a further hearing to resolve undecided issues — such as the calculation of interest payable — once the final amount of recoverable VAT was known.

Comments - The FTT's acceptance that a lower standard of evidence may apply to Fleming claims in circumstances where the claims go back a number of years may be useful to taxpayers.

St George's Healthcare NHS Trust v HMRC TC3308

Issue of security notice by HMRC

The FTT allowed the appeal against HMRC's issue of a security notice under VATA 1994 Sch 11 para 4.

The taxpayer had understood from correspondence and discussions with HMRC that it was tacitly agreed that the company would be able to retain as working capital a sum of VAT which would otherwise be payable and that no amount would be payable until the conclusion of MTIC proceedings. This was the reason why the taxpayer had reduced payments of VAT after HMRC had refused to repay input tax (because of the alleged connection to MTIC fraud).

Decision:

Although the FTT accepted that it had no jurisdiction on the question of the appellant's 'reasonable expectation', it stressed that this expectation should have been taken into account by HMRC when considering whether to issue the notice. The FTT criticised HMRC for failing to take into account the taxpayer's faultless compliance record and creditworthiness and the serious consequences of this notice to the business. Additionally, the FTT questioned the disproportionate amount of the security notice, which went beyond the denied input tax — the only amount at risk.

Comments - Decisions on security notices are few and far between. This decision, which was in favour of the taxpayer, should therefore be a useful reference for a compliant taxpayer in receipt of such a notice.

Aria Technology Ltd v HMRC TC3410

Caravans: items subject to zero-rating

The UT allowed HMRC's appeal in part. The appeal turned on the identification of which contents of a static caravan were zero-rated (VATA 1994 Sch 8 Group 9).

The FTT had set out a twofold test: does the removal of the item still leave a habitable caravan; and how easily can the item be removed?

Decision:

The UT considered that the test set out by the FTT was wrong. Referring to University of Kent (2004 – 18625), the UT insisted that the legislation does not introduce a 'fitness for habitation test'. Furthermore, the use of the word 'removable' simply confirms the distinction between the container and the content. Therefore, carpets, ovens, settees, etc are removable as they have been incorporated into the shell of the caravan and can therefore be unincorporated.

The UT added that the removability test introduced by the FTT would create uncertainty; how easily an item could be removed would depend on the skills of the remover. Additionally, caravan manufacturers might endeavour to glue items to make them more difficult to remove.

The UT therefore allowed HMRC's appeal in respect of carpet, oven and hob. These items were standard-rated regardless of how they were fixed as they were removable and not of a kind with building materials.

Comments - This decision is the latest instalment in a judicial saga which spans many years and several parallel proceedings. By refusing to adopt a more specific test than that set out in the legislation, the UT may have left the door open to more issues.

HMRC v Colaingrove (FTC/20/2013)

Partially exempt business: residual input tax

The museum successfully claimed that VAT on expenditure incurred in refurbishing and maintaining its exhibits was residual input tax, as it had a direct and immediate link — for the purpose of the BLP test (C-4/94) — not only with the museum's exempt supplies of admissions but also with taxable supplies made in the museum shop.

It was accepted that the whole of the VAT incurred on refurbishing and maintaining exhibits would be residual input tax if a direct and immediate link could be established with at least one taxable supply, no matter how small (Mayflower [2006] EWCA Civ 116).

Decision:

The tribunal found that items sold in the museum shop could be sold in any shop and that the exhibit costs were not a component of the supply of those items, which was 'freestanding' from the admission

of visitors. The facts that it would be rare for someone to purchase an item without visiting the museum or that sales were generated mainly by the existence of the exhibits were not relevant. This even applied to photos taken in the gallery, including photos of exhibits. Their costs were not part of the gallery costs, in the same way as the cost of a photograph of a building could not include the cost of its construction.

However, the FTT accepted that the design of a 'Hut Book' (which was sold in the museum shop) had been part of the overall gallery costs, as it was the means by which the museum explained to visitors what they were looking at. There was therefore a direct and immediate link between the cost of the services provided by the supplier of the Hut Book and one of the taxable supplies made by the museum.

Comments - The case is a useful example of a practical application of the BLP test (focusing on cost components) when establishing what constitutes residual input tax for a business which makes both exempt and taxable supplies.

The Roald Dahl Museum v HMRC TC3445

No retrospection

In April 2011, the taxpayer, an archaeological consultancy, wrote to HMRC asking to backdate the company's application to join the VAT flat rate scheme to 2004. The consultancy had already submitted its VAT returns for the periods to 31 December 2010, but was having difficulties paying the VAT due and had only just become aware of the flat rate scheme.

HMRC refused on the basis that the purpose of the scheme was to simplify VAT accounting rather than save tax and, although the legislation gave them power to backdate an application, such a request would be refused if a VAT return for a period had already been submitted based on normal accounting.

Decision:

The First-tier Tribunal said that HMRC do not tell taxpayers how to save tax, but do offer help. However, a taxpayer's lack of knowledge is not the fault of HMRC. It was understandable that a taxpayer would feel aggrieved that they could have paid less VAT by using the flat rate scheme, but HMRC had not behaved unreasonably. In fact, they had offered an earlier start date for the scheme which the tribunal thought was a “reasonable offer”. The taxpayer's appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, said: “A key feature of this case is that the taxpayer was heavily critical of its tax advisers for failing to highlight the benefits of the flat rate scheme for many years, even though the company was struggling to pay its VAT liabilities and, as a service business with little input tax, would have saved large amounts of tax by adopting the scheme. The taxpayer said his advisers 'should have advised that the flat rate scheme was available to be joined. They said that they were tax specialists and it was unjust to force us to pay the penalty for their mistakes while they get away scot-free'. The message is clear: the potential benefits of the flat rate scheme for many small and medium-sized enterprises should not be forgotten.”

C & N Hollinrake Ltd v HMRC TC3343

Secret attraction to VAT

Customers of the taxpayers, a series of lap dancing clubs called Secrets, could pay dancers for table company, where the dancer would sit and chat, or for private dances. The customers could pay in cash or use Secrets money. The latter consisted of face-value vouchers that could be bought by a debit or credit card at the club. The vouchers were subject to a 20% commission which was added to the face value. The dancer redeemed the vouchers less a 20% charge. (See Mike Truman's article “Quashie quashed”, 24 January 2013 for a report on an employment tribunal decision on the employment status of a lapdancer.)

It was agreed that the 20% commission charged by the club to the customer was consideration for a taxable supply under VATA 1994, Sch 10 para 2 and para 4. It was also agreed that the 20% commission taken from the dancer was consideration for a supply by the company to the dancer. The issue concerned the nature of the supply. The taxpayers claimed they were making an exempt supply of handling money (Sch 9 group 5 item 1).

HMRC said the vouchers were not security for money. The club was providing the dancer with performance facilities which constituted a taxable supply.

Decision:

The First-tier Tribunal concluded that the dancers were retailers in that they supplied services to the taxpayers' customers. The clubs provided a single supply of taxable services to the dancers, for which the dancers paid an entry fee for each evening they danced and the value of the 20% commission paid in relation to the vouchers. The judge acknowledged that, if considered individually, each step appeared to support the taxpayers' case but accepted HMRC's argument that there was a composite supply of which the redemption of Secrets money was an ancillary part.

The taxpayers' appeal was dismissed.

Comments - Neil Warren, independent VAT consultant, said: “Although the tribunal accepted that Secrets money represented a 'security for money' as defined by group 5 item 1, the key issue was to consider the nature of the supplies made by the clubs to the dancers. This was deemed not to be a payment handling service that could be exempt from VAT. The decision is consistent with other tribunal cases, and is another example of how VAT issues can get complicated when three parties are involved in a transaction.”

WiltonPark Ltd and others v HMRC TC3255

Bad debt relief claim fails

BT lost its £62m claim (under bad debt relief VATA 1983 s 22) for a refund of VAT accounted for on supplies made before 31 March 1989, in respect of amounts unpaid by its defaulting customers.

A condition of the relief was that the customer must be insolvent. This condition was not satisfied in some cases and so BT claimed that it had a directly enforceable right under the Principal VAT Directive 2006/112/EC art 11C(1). BT also asserted this right in respect of pre-April 1989 periods, in relation to which claims under national legislation were barred by FA 1997 s 39(5).

Decision:

The first issue was therefore whether art 11C(1) had been capable of having direct effect. Art 11C(1) provided that in cases of partial or total non-payment by customers, 'the taxable amount shall be reduced accordingly under conditions which shall be determined by member states'. The court robustly rejected arguments that, until member states prescribed the conditions, the right conferred by art 11(C) was too imprecise to be directly effective. The word 'accordingly' prescribed a reduction arithmetically proportionate to the price reduction; and the 'conditions' referred to in the provision pointed to formalities rather than matters of substance. Furthermore, the power of derogation afforded by the second part of art 11 (C) was not to be used to deprive a class of taxpayers of their rights but may be used to counter tax avoidance.

The Court of Appeal next determined the issue of the proportionality of the insolvency condition. It found that the manifest effect of the test was to exclude from the relief small debts which were bad. This was because debts owed by individuals were too small for BT to start bankruptcy proceedings and it would have been too costly to obtain a winding up in relation to debtors which were companies. The condition therefore deprived a wide class of creditors of their rights and, as such, was unlawful.

As to the applicable time limits, the court distinguished between supplies made from 1 January 1978 and 30 September 1978 and supplies made from 1 October 1978 to 31 March 1989. As regards the claims made in relation to the first period, no bad debt relief existed under national legislation. BT therefore had a directly enforceable right under European Law, which was subject to the common law domestic limitation of six years applicable to claims of a restitutionary nature. For the latter period, BT should have claimed under domestic legislation for cases in which the insolvency condition was satisfied. BT could also have claimed under the Directive but the procedural way would have been to claim under domestic legislation – with some adaptation on the basis that the insolvency condition was unlawful; therefore, the domestic provisions on time limits applied. The court added that, to the extent that the relevant provisions imposed time limits which were inapplicable to BT's claim (as they referred to the receipt of insolvency documents), those time limits would be disapplied.

Finally, the court rejected BT's contention that the demise of the 'old' bad debt scheme by FA 1997 had infringed its directly enforceable right, pointing out that the only reason BT had been so slow in bringing 20 year old claims was that it had been unaware of them. The court considered that 'a prudent and circumspect operator' would have been aware of its EU right and claimed within the time limit.

Comments - The decision is likely to deter other late claimers. It is of course great news for HMRC, which is still fighting a number of multi-billion pound claims for the refund of VAT believed to have been wrongly paid.

BT v HMRC (A3/2012/3096)

Supply of pathology services

The FTT held that supplies of pathology services (testing samples of body fluid, tissue, etc) by GSTS to three NHS Trusts were exempt from VAT.

The FTT rejected GSTS's submission that it did not provide medical care (for the purpose of the Sixth VAT Directive art 13) as its supplies did not have a 'therapeutic purpose'. Referring to D v W (C-384/98), Unterpertinger (C-212/01) and d'Ambrumenil (C-307/01), the FTT explained that there was a distinction between services provided for the purpose of 'protecting, maintaining or restoring human health', and services which had another purpose, for instance, informing a judicial decision. Although GSTS's activities did not have the direct effect of protecting, maintaining or restoring health, they did meet the second purpose.

Furthermore, the FTT referred to LuP (C-106/05) as authority for the proposition that an 'upstream' supply of pathology testing is medical care. The FTT also rejected objections relating to the facts that the pathology services were supplied to doctors, not patients, with whom GSTS had no contact. It noted that the route of the supply could not affect its nature and that medical care could be administered without contact with a patient, for instance, when a senior doctor reviews a case with a junior doctor.

Finally, the tribunal found that the UK had not exceeded the discretion conferred by the Sixth VAT Directive when treating GSTS as a 'body similar to a hospital or centre for medical treatment or diagnosis' (VATA 1994 Sch 8 Group 7 note 8). The FTT noted that EU law did not impose a duty on member states to make exemptions unavailable, on the ground that standard-rate treatment would be more advantageous.

Comments - The Tribunal noted that the effect of the judgment was that GSTS would be unable to recover input tax and would have to reflect this in the price charged to hospitals. Additionally, GSTS had structured its supplies on the basis of an HMRC ruling that the supplies would be standard-rated. However, the FTT considered itself bound by CJEU case law.

GSTS Pathology Services LLP v HMRC TC3351