# Tolley®CPD

June 2014

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# Contents

# Personal Tax

## Rectifying a deed of variation

The claimant was applying for rectification of a deed of variation which purported to alter the provisions of a will to reduce inheritance tax.

Hilda had died on 6 February 2006 and her sister Ellen on 11 September 2007. Ellen was a beneficiary under Hilda's will. Like Hilda, Ellen left some specific legacies and the residue of her estate to four charities. The combined effect of the two wills was that the assets that had passed to Ellen under Hilda's will and then to the charities were subject to inheritance tax. The claimant (who was the administrator of Hilda's estate and the executor of Ellen's estate) had entered into a deed of variation to redirect Ellen's entitlement under Hilda's will to the four charities in order to avoid the inheritance tax. However, the effect of the wording of the deed was that the specific devise of a property to Ellen under Hilda's will was unchanged. The deed only affected the residue of Hilda's estate. The claimant therefore applied for rectification of the deed of variation, as the drafting had not produced its intended effect.

*Decision:*

The court noted that proof of the error was established by the letters the claimant had sent to the four charities which set out the purpose of the variation. Furthermore, the error related to the intended effect of the document and not to its consequences and the specific intention of the claimant was established. Finally, the effect of the order of rectification would not be only to secure tax advantages. In particular, the four charities had intimated that they had a negligence claim against the claimant (who was a solicitor) in relation to the bad drafting of the deed. All the conditions set out in Racal [1995] STC 1151 were therefore satisfied. The relief should be granted.

**Comments -** The case is a useful example of the way a court will examine an application for rectification.

*Giles v The Royal National Institute for the Blind HC13B04831*

## Was a loan to an employee 'employment related'?

The FTT held that a loan granted to an employee on commercial terms available to the general public was not an 'employment-related loan'.

Mrs Amri was an employee of HBOS when she obtained two loans from Halifax, a division of HBOS. She received a letter from Halifax notifying her that her 'new mortgage account' was open. The letter referred to two loans. The first loan, for £35,000, was on preferential terms for employees of HBOS; whereas the second loan, for £105,000, was on normal commercial terms available to the general public. HMRC contended that Mrs Amri had been granted a single loan by her employer and so the total amount of £140,000 was taxable as a benefit in kind. HMRC relied in particular on the letter sent to Mrs

Amri, which referred to a single mortgage account and to the fact that the average interest paid for both loans was lower than the commercial rate.

*Decision:*

The FTT rejected HMRC's interpretation of the legislation (ITEPA 2003 s 173) as an 'employment-related loan' does not cover 'any kind of advance by reason of employment'. Furthermore, the second loan met one of the conditions of s 176(3); it had been granted on terms available to the general public. Mrs Amri had originally approached Halifax seeking a loan on ordinary commercial terms for the entire amount and had only thereafter found out that she could obtain £35,000 on preferential terms.

**Comments -** It can be sometimes difficult for employees to establish that a loan granted to them is not on preferential terms. Mrs Amri was however fortunate to have first sought a loan on ordinary commercial terms. This may be a useful precaution for any employee wishing to take a loan from their employer.

*Elizabeth Amri v HMRC TC3451*

## Loss of EIS relief on merger

The First-tier Tribunal (FTT) held that the taxpayers had forfeited their right to enterprise investment scheme (EIS) relief as a result of a merger implemented as a reverse takeover.

The taxpayers had subscribed shares in a start-up company called ProtonStar. The company traded in LED lighting and all the conditions for EIS relief were satisfied. Another company, Enfis, which engaged in a similar trade had been formed slightly earlier; Enfis had, however, secured an alternate investment market (AIM listing) which made it valuable. However, the AIM listing would be lost if ProtonStar were to acquire Enfis, so the two companies were merged by way of a reverse takeover. Enfis dropped its trade to a newly incorporated subsidiary. Enfis then acquired all the shares in ProtonStar in exchange for an issue of 78% of the enlarged capital of Enfis, leaving the old Enfis shareholders with 22% of the shares of Enfis. The name of Enfis was then changed to ProtonStar LED Group PLC ('Group'). The result therefore was that Group held both subsidiaries: ProtonStar; and the subsidiary to which Enfis's trade had been transferred. Clearance was obtained from HMRC confirming that the transaction was effected for bona fide commercial reasons for the purposes of CGT relief. HMRC also confirmed that EIS relief should continue to apply. Furthermore, the number of employees of the new group was kept below 50 in order to preserve EIS.

The issue was whether the transaction had resulted in the forfeiture of EIS relief for the pre-existing shareholders in ProtonStar. EIS relief is forfeited if the company comes under the control of another company within three years of the issue of shares (ITA 2007 s 185).

*Decision:*

The FTT observed that there is no qualification of this rule, in particular for cases such as this one, where the original shareholders ultimately remain in control of the company.

Furthermore, EIS relief is withdrawn if the shareholders dispose of their shares within three years (ITA 2007 s 209). Again, the fact that the shareholders had simply swapped their shares in ProtonStar for shares in Enfis — with the effect that relief from CGT was achieved — was irrelevant for the purposes of EIS, which followed a different code from CGT.

The FTT noted that ITA 2007 s 247 was drafted in a 'slightly curious manner', as it disapplied both s 185 and s 209 only where the company acquiring the EIS company has only subscriber shares in issue. This was clearly not the case for Enfis. Therefore, ss 185 and 209 were not disapplied, even though the shareholders of the new Group were substantially the same as those of ProtonStar (as required by other similar provisions on mergers).

The FTT understood the taxpayers' claim that 'it was inconceivable that Parliament had intended the old ProtonStar shareholders to forfeit their relief when: Enfis had also been a trading company whose shareholders had qualified for EIS relief; the other conditions for the preservation of EIS relief for the ProtonStar shareholders had been satisfied; HMRC had confirmed that any new shares issued by Group would potentially qualify for EIS relief; and the merger of the two companies was entirely commercial.'

However, the UT was unable to widen the application of s 247 by giving the term 'subscriber shares' a meaning other than 'shares issued to the subscribers of the memorandum of association'. The UT added that it was also unable to explain why the application of the relief in s 247 should be limited to situations where a pure new holding company is superimposed.

**Comments -** This case is a warning tale for any holders of EIS shares; a reverse takeover must be structured very carefully (using a brand new holding company) if relief is to be preserved. More widely, this is also a reminder of the limited power of judges when faced with a result which was not intended by Parliament.

*Finn & others v HMRC TC3555*

## Income tax scheme failed

Mr Ferguson wished to shelter £500,000 of his employment income from tax.

He implemented a scheme which relied on the 'gifts to charities' rules, which allow individuals to deduct from their income for tax purposes the market value of any shares or similar assets they give to charities. The arrangements were intended to give rise to the relief under those rules, while passing on 99% of the value of the assets (which were gilts) 'given' to the charity to a family trust for the benefit of Mr Ferguson and his family. The key issue was therefore whether Mr Ferguson had disposed of the beneficial interest in the gilts to a charity.

HMRC contended, firstly, that to allow the relief would ignore the purposive approach of ICTA 1988 s 587B, which was to encourage charitable giving. Secondly, HMRC argued that only 1% of the gilts had actually been donated to the charity due to pre-existing option and security arrangements. Lastly, HMRC insisted that the donation 'lacked donative intent'.

*Decision:*

Referring to Berry [2011] UKUT 81, the FTT observed that the transactions had to be tested against the relevant provision (s 587B). That the provision was not highly prescriptive, so its purpose — to encourage charitable giving — was relevant. The transaction was a composite transaction and therefore its overall effect had to be ascertained. As the transaction had resulted in a transfer of 99% of the gilts to a trust for the benefit of Mr Ferguson's family, it did not satisfy the requirement of s 587B. Even if it was accepted that 100% of the gilts had been gifted to the charity, the requirement of s 587B would still not be satisfied as the disposal was made 'on tightly agreed terms' and therefore was a bargain at arm's length. The FTT did not consider the other arguments put forward by HMRC.

**Comments -** This is a practical example of the application of the guidance in Berry. It is also a clear reminder (following UBS [2014] EWCA Civ 452) that provisions which are not highly prescriptive can be subject to a purpose test.

*Ferguson v HMRC TC3562*

## Further NIC Class 3 payments permitted

The appellant, an Australian citizen, worked in the UK from 1988 to 1991. In 2008, after reading press articles and discussions with a UK citizen, he realised that he could make additional UK National Insurance contributions. In 2008, he completed a form CA5603 and sent it to HMRC. Later that year, HMRC issued a forecast of his UK state pension, but the appellant said he did not receive the notice and HMRC did not retain a copy.

Nothing further happened until 2010 when the appellant contacted the department and, in 2011, HMRC wrote to him inviting him to make voluntary class 3 contributions going back to the 2004/05 tax year. The appellant made the payment and asked if he could make payments for earlier years. HMRC said he could not make voluntary class 2 payments because the time limits had expired.

The taxpayer appealed.

*Decision:*

The First-tier Tribunal said that the appellant had taken the positive step of contacting HMRC about his National Insurance contributions in 2008, although he had not followed up his enquiries again until 2010. HMRC said he should have continued his initial enquiries rather than leave them until 2010. Had he done so, he would have been in time to make further voluntary contributions.

The judge noted that the appellant lived in Australia and had been in the UK for only a short time. The evidence was that he was unaware of deadlines and “was acknowledged to be in ignorance of the National Insurance system”.

In this instance, the tribunal decided the appellant's ignorance and error was not the result of a failure to take due care.

The taxpayer's appeal was allowed and the judge hoped he would be given “a sensible opportunity” to make more contributions.

**Comments –** This case is an example of the importance of taking the appropriate actions within the appropriate time limits. This is another case where HMRC adopt the stance that additional voluntary contributions are out of time and therefore not capable of being made. This case is not unique but the latest where the judge has looked at the knowledge of the relevant taxpayer who has often spent a limited amount of time in the UK but a significant period of time in an overseas jurisdiction and therefore will not understand the intricacies of the UK NIC system.

*WKF McPherson v HMRC TC3456*

## Employee Benefits In Kind and Expenses

The government has announced that it will shortly be launching a package of four related consultations on employee benefits in kind and expenses.

The consulations derive from proposals to reduce administrative burdens made by the Office of Tax Simplification. There will also be a longer term review of the tax treatment of travel and subsistence expenses, and a call for evidence on modern remuneration practices.

The four areas of consultation are:

- The abolition of the £8,500 threshold. The government believes that this threshold adds unnecessary complexity to the tax system and is consulting on how to mitigate the effects of abolition on vulnerable groups of employees.
- Introducing a statutory exemption for trivial benefits in kind. The government believes that a clear and simple statutory exemption will make administering such benefits substantially easier for employers.
- Replacing the current system of dispensations for reporting non-taxable expenses with a general business expenses exemption. The government believes that an exemption would be simpler, more transparent, consistent and easier to use for employers than the current system.
- Introducing a system of voluntary payrolling for benefits in kind. The government believes that payrolling benefits in kind instead of submitting forms P11D can offer substantial administrative savings for some employers and wishes to create a system to empower employers to do so if they feel it to be beneficial. The government will consult on the design and scope of a payrolling model and is interested to hear also from employers who are already doing this on an informal basis, and what ‘payrolling’ means to them.

*Travel and subsistence*

The OTS report also identified a number of issues with the tax treatment of travel and subsistence expenses which are a cause of error, misunderstanding, and concern for employers. The government’s view is that these problems are symptomatic of more fundamental issues in the tax rules on travel and subsistence expenses, and intends to launch a longer term review of the rules alongside the above consultations.

The review of the travel and subsistence will aim to produce a new system that reflects working patterns in the 21st century. The government does not intend that any new system would provide relief for private travel or ordinary commuting. However, the government is open to exploring different principles and methods for determining when travel expenses should attract tax relief and will invite views on this in a structured way as part of the review.

*Remuneration*

The OTS also highlighted the wider need to reform policy to reflect the 21st century workplace and labour market. The government is therefore committed to looking at how remuneration practices are changing and to ensure the tax system keeps pace. There will therefore be a general call for evidence on modern remuneration practices to inform any future policy changes in this area.

## Scrapping of the renewals basis **(Lecture P837 – 11.10 minutes)**

The tax legislation provides for a deduction for the cost of renewing "trade tools" (see ITTOIA 2005, s 68). Strictly, the legislation applies only to small items such as hammers, chisels and so on, but by concession the relief has been extended to any items of plant and machinery.

The allowance works on the basis that you cannot have a deduction for the first purchase of an item of plant, so when fitting out a new rental property, there is no deduction for buying, say, a cooker. When the cooker needs replacing, however, the cost of the replacement can be claimed as a "renewal".

The renewals allowance applies to any trader, but it is particularly useful for landlords of residential accommodation as capital allowances are not available.

Prior to April 2013, the landlord of a furnished property has always had a choice: he could claim the renewals allowance, or he could claim a "wear and tear" allowance calculated as 10% of the rent he receives. Wherever possible the 10% wear and tear allowance is generally claimed.

If the property was not fully furnished (eg kitchen appliances only), then the wear and tear allowance is not available. The renewals basis would be the only option for a partly furnished property.

At BIM46990 HMRC state that the renewals basis will not apply to expenditure on replacing plant and machinery which is incurred:

(a) on or after 6 April 2013, for the purposes of income tax; and

(b) on or after 1 April 2013, for the purposes of corporation tax.

The strict statutory allowance for "trade tools" will remain but this is may not to be much help for landlords.

From April 2013, it would appear that the only relief available to residential landlords will therefore be the wear and tear allowance, and this can only be claimed for fully furnished properties, so landlords of unfurnished residential accommodation will not be able to claim any relief at all for replacing such items as cookers, fridges, dishwashers, and so on.

There is an alternative argument that maintains that cookers etc would qualify as "trade tools" and are therefore still deductible under statute rather than the renewals basis. The case of Caledonian Railways established that rolling stock could be treated as "trade tools" so is it reasonable to extend that argument to fridges and cookers in a partly furnished buy to let?

Due to the uncertainty in this area, a joint letter was sent by the Private Client Committee of the ICAEW Tax Faculty and the Property Taxes Sub-Committee of The Chartered Institute of Tax to HMRC in February 2014 asking whether s.68 extended to white goods etc in a partly furnished property.

Extract of HMRC reply dated 7 April 2014:

*For clarity, I set out the full history behind the withdrawal of the extra-statutory concession.*

*Background*

*Relief to property businesses under the non-statutory renewals allowance (BIM46980 and PIM3230) was an extra-statutory concession (ESC B47) for furnished property. Additionally, the PIM guidance concession went further than the ESC and covered unfurnished property also. Both of these concessions were withdrawn following a period of consultation as part of the review of extra statutory concessions following the House of Lords decision in CIR v Wilkinson. However, this was not a legislative change.*

*The House of Lords‟ decision in the Wilkinson case clarified the scope of HMRC‟s administrative discretion to make concessions that depart from the strict statutory position. In light of that decision HMRC reviewed its concessions and published consultations seeking comments.*

*A document entitled "Withdrawal of extra statutory concessions -Technical note and call for evidence" was published on 6 December 2011 explaining the position, which you have referred to in your letter. Data and evidence was requested by November 2012 on the potential impact of the withdrawal.*

*HMRC worked with the British Property Federation (BPF) to find out more about the type of assets that are likely to be used in semi-furnished and unfurnished lettings and the likely impact of making the proposed changes.*

*The BPF is not the only professional body with which HMRC consults on property business tax issues. However, they were the only body which specifically contacted HMRC in response to the request for evidence and data made in the document "Withdrawal of extra statutory concessions – Technical note and call for evidence". This document was published on HMRC‟s website and would have been picked up at the time on the news-feeds of relevant lettings publications. By comparison with the usual practice for tax consultations, the timetable for responses was particularly generous, as evidence could be submitted any time before the end of November 2012.*

*HMRC did not receive any evidence to suggest that unfurnished nor semi-furnished property businesses would be significantly affected. The replies suggested that there was no standard practice for what items might be found in an unfurnished or semi-furnished property and that the only items regularly included in such properties are fitted ovens and hobs, replacement of which would be treated as a repair.*

*Although a cooker point was a necessity the supply of a free standing cooker or any other free standing "white goods" was a matter of individual choice and varied from area to area. In new build developments major kitchen appliances were likely to be integral fittings. In this case their replacement would come under the category of repairs. The provision of sanitary and kitchen units was also cited but again replacement of these items would be a repair. Respondents generally agreed that floor coverings and curtains would usually be supplied.*

*In addition to the BPF coordinated response, HMRC received a small number of other replies which reflected the above points. Given the level of response and the fact that it appeared that the capital expenditure on replacement items would generally be limited to occasional updates of curtains and carpets, HMRC proceeded with the withdrawal announced in the technical note. HMRC acknowledged in that note that the withdrawal of the concession for unfurnished and semi- furnished properties could leave some businesses worse off but that that would very much depend on the facts of the case. Additionally, the yield from withdrawing the five listed extra statutory concessions was likely to be relatively small and was not a significant consideration. However there could be a more substantial negative impact on the Exchequer if the various reliefs given by the extra-statutory concessions due for withdrawal in April 2013 were legislated. This was because legislation could provide unforeseen opportunities for avoidance in a way that concessions do not.*

*Impact*

*As a result of the withdrawal, concessional treatment does not apply in relation to expenditure on replacing plant and machinery which is incurred:*

- *on or after 6 April 2013, for the purposes of Income Tax; and*
- *on or after 1 April 2013, for the purposes of Corporation Tax.*

*Relief for property businesses (furnished and unfurnished) is still available to a limited extent, as explained below.*

*<u>Repairs</u>*

*Relief is available on repairs for furnished, part-furnished and unfurnished properties.*

*HMRC Guidance for relief on repairs concerning furnished, part-furnished, and unfurnished lettings is at BIM46900. This is updated guidance.*

*<u>Renewals (Statutory Renewals Allowance)</u>*

*Relief is available under the statutory renewals allowance on renewals for furnished, part-furnished and unfurnished properties. However, the statutory renewals allowance is very limited in application.*

*Legislation for this relief is at s.68 ITTOIA 2005 for Income Tax purposes and s.68 CTA 2009 for Corporation Tax purposes. Although the extent to which relief is available on items is not the same as was the case under the extra-statutory concession.*

*HMRC Guidance for relief on renewals concerning furnished, part-furnished and unfurnished lettings is at BIM46960 (Statutory Renewals Allowance). Again, this is updated guidance.*

*The statutory renewals allowance at s.68 ITTOIA 2005 and s.68 CTA 2009 can be taken out of context as referring to all items that an unfurnished and furnished property business previously was entitled to renewals on under the extra-statutory concession. However, this is not the correct position.*

*Both s.68 ITTOIA 2005 and s.68 CTA 2009 relate only to items of a capital nature that are of a relatively low value and have a short useful economic life that would need to be regularly (almost annually, but not necessarily) replaced in the ordinary course of business due to normal wear and tear. This would be on items such as crockery and rugs for instance, i.e. low cost soft furnishings that might be expected to be replaced fairly regularly. However, it would not apply to carpets, for instance, as they are a capital item of potentially higher value that you would not expect to regularly replace ordinarily. However, landlords may be able to get some relief on carpets if the expenditure qualifies as a revenue expense.*

*White goods such as washing machines and refrigerators are not covered by the statutory renewals allowance as they are capital items not part of the entirety (the property). However, where the white goods are fitted (i.e. integrated hobs and ovens), we recognise these are part of the entirety (the property) and so these would be deductible as a repair when replaced (see above).*

*To confirm therefore, anything free-standing, such as a fridge freezer, will not become part of the entirety (the property) for residential lettings and therefore would not be deductible under s.68 ITTOIA 2005 / s.68 CTA 2009.*

*Although the extent to which relief on items is available for semi-furnished and unfurnished dwellings is not the same as was the case under the extra-statutory concession, I can assure you that HMRC is continuing to review the impacts of the change.*

*Relief under s.68 ITTOIA 2005 / s.68 CTA 2009 is not available if relief has already been claimed under s.308A ITTOIA 2005 or s.248A CTA 2009 for Wear & Tear (explained below)*

*Your letter referred to an example in BIM46911 of Sophia refitting a kitchen. The example had been omitted due to a technical error when publishing the updated BIM. I apologise for the confusion this may have caused and can confirm the example will be added back into BIM46911. For completeness, I clarify the tax position of that example below.*

*Replacement of the fridge freezer is capital expenditure on a new asset used in a dwelling house which is not part of the entirety (the property) and therefore is ineligible for relief as it is not a repair. For the same reason the replacement is ineligible for relief under s.68 ITTOIA 2005 and s.68 CTA 2009. This is the case whether the residential property is furnished or unfurnished. Capital allowances are not available for furniture and household equipment provided for use by tenants in residential dwellings (PIM3010).*

*<u>Wear & Tear (10% Statutory Allowance)</u>*

*You have acknowledged that the wear and tear allowance continues to be available for furnished lettings and so have no query about this. I have therefore merely provided the information below on wear and tear for completeness.*

*The statutory wear and tear allowance is only available in respect of fully furnished lettings.*

*Whether a property is fully furnished or not is a matter of fact. To qualify as a furnished residential letting the property has to be a dwelling house that is let with sufficient furniture, furnishings and equipment for normal residential use.*

*Legislation for the wear and tear allowance is at s.308A ITTOIA 2005 for Income Tax purposes and s.248A CTA 2009 for Corporation Tax purposes. HMRC Guidance for relief on furnished lettings is available at PIM3205. This guidance has recently been updated.*

*Landlords can elect to deduct a wear and tear allowance of 10% of net rent (i.e. rent less expenses such as utilities, council tax, and anything else the tenant is usually responsible for) as an expense of their property business.*

*This election means that instead of claiming relief for replacing utensils or repairing furniture (under s.68 ITTOIA 2005 or s.68 CTA 2009 as explained above for statutory renewals allowance), the taxpayers deduct an allowance calculated as a percentage of rents received. The option to elect for a wear and tear allowance is only available for lettings of furnished dwelling houses.*

The Tax Faculty comment on the HMRC reply as follows:

"The response from HMRC is that in its view no claim can be made for stand-alone white goods, as they do not qualify for relief under s68, Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005) which applies to capital items of a relatively low value and not, for example, a fridge. If the white goods are integral in a fitted kitchen then replacement could be claimed as a repair but there is no tax relief for replacing them on a stand-alone basis.

When the consultation on the withdrawal of ESC B47 was published, HMRC had very little response. But that could be because HMRC's background note said: "…. relief will be available either under Section 68 ITTOIA 2005/Section 68 CTA 2009 or, for furnished lettings, under the wear and tear allowance at Sections 308A to 308C ITTOIA 2005" – which would have reassured readers who might have had a concern on first learning that the ESC was to be withdrawn.

We suspect the change in policy will come as a surprise to many landlords as they complete their self-assessments for 2013/14 – that is if unrepresented landlords even realise there is a change. The notes to the SA105 for 2013/14 highlight the change, but without an alert many taxpayers may not consult the notes. HMRC will continue to monitor the impact of the withdrawal, so the door on relief may not be fully closed."

**Comments –** It is reassuring for HMRC to confirm that the more expensive built-in appliances are regarded as fixtures and are hence deductible when replaced. The scrapping of the renewals basis and HMRCs contention that s.68 does not give an alternative deduction for free standing appliances, curtains and carpets is disappointing. It would however appear that smaller items which are regularly replaced e.g. toaster, crockery, cutlery, tin can opener etc do fall within s.68 and are hence deductible where the client is not claiming the 10% wear and tear allowance. Where the client is claiming the wear and tear allowance then the allowance covers the renewal of such items.

Furthermore, if the client is claiming the wear and tear allowance it would be reasonable to assume that the replacement of built-in appliances (ovens, fridges etc) is deductible in full when replaced i.e. they fall outside of the wear and tear deduction as they are regarded as fixtures.

## New starting rate for savings **(Lecture P836 – 13.11 minutes)**

In 2014/15 (as in previous years), there is a 10% starting rate which only applies to an individual's savings income. The upper limit for this rate is currently £2,880.

S16 ITA 2007 sets out the ordering rules for the different sources of income received by an individual: broadly speaking, dividends are treated as the highest part of an individual's total income followed by savings income (ie. bank and building society interest). The lowest slice is the individual's non-savings income (that is, salary, benefits, business profits, pensions and income from property) which is effectively taxed first. The 10% starting rate is only in point for recipients of interest whose non-savings income does not exceed their personal allowance plus £2,880. In many cases, these will be elderly people with modest pensions and a certain amount of interest – see the illustrations which follow.

*Illustration 1*

Angela, who was born in May 1948, received a pension of £7,900 and interest of £4,880 for 2014/15. The pension is paid gross, but Angela's interest is subject to a 20% tax deduction at source.

Angela's tax position for 2014/15 is:

| | £ |
|---|---|
| Pension | 7,900 |
| Interest (x 100/80) | 6,100 |
| | 14,000 |
| Less: PA | 10,000 |
| | £4,000 |

Angela's personal allowance for 2014/15 is set first against her pension and so none of this is taxable. All of Angela's taxable income is savings income. The first £2,880 is charged at the special starting rate for savings of 10% and the balance is taxed at the basic rate of 20%. Thus:

| | | £ |
|---|---|---|
| 2,880 @ 10% | | 288 |
| 1,120 @ 20% | | 224 |
| | | 512 |
| Less: | Tax deducted at source (20% x 6,100) | 1,220 |
| REPAYMENT DUE | | £(708) |

*Illustration 2*

In 2014/15, George, who was born in January 1977, had earnings from a part-time employment amounting to £10,750 (from which PAYE of £150 was deducted) and building society interest of £2,720 (net).

George's tax position for 2014/15 is:

| | | £ |
|---|---|---|
| Earnings | | 10,750 |
| BSI (x 100/80) | | 3,400 |
| | | 14,150 |
| Less: | PA | 10,000 |
| | | £4,150 |

George's personal allowance for 2014/15 is set against his earnings, leaving £750 to be taxed at 20%. The rest of George's starting rate limit for savings (£2,880 – £750 = £2,130) can be used against his building society interest of £3,400. The balance of his interest is taxed at 20%. Thus:

| | | £ |
|---|---|---|
| 2,130 @ 10% | | 213 |
| 1,270 @ 20% | | 254 |
| | | 467 |
| Less: | Tax deducted at source (20% x 3,400) | 680 |
| REPAYMENT DUE | | £(213) |

Following an announcement by the Chancellor in his Budget Speech on 19 March 2014, Cl 3 FB 2014 confirms that for 2015/16:

- the starting rate for savings will be reduced to 0%; and
- the starting rate limit will rise to £5,000.

The rationale for this change was explained by the Treasury in the paragraph below:

> *'This change is designed to support savers (particularly low income savers) by, firstly, enabling more people to benefit from the starting rate for savings and, secondly, by reducing this rate to nil. The effect will be to remove the savings income of many lower income savers from liability to tax for 2015/16. It also simplifies processes around the starting rate for savings by enabling eligible savers to register with their bank or building society to receive interest on their savings without tax being deducted, rather than having to reclaim tax they have paid on interest from HMRC.'*

A comparison of the tax effects of the old and the new rules is set out in Illustration 3.

*Illustration 3*

In 2015/16, Trevor receives a pension of £9,200 (no tax deducted), income from a rented property of £1,000 and bank interest of £4,800 (net). His personal allowance for that year is £10,500.
Trevor's tax position for 2015/16 will be:

| | | £ |
|---|---|---|
| Pension | | 9,200 |
| Property income | | 1,000 |
| Bank interest (x 100/80) | | 6,000 |
| | | 16,200 |
| Less: | PA | 10,500 |
| | | £5,700 |

Trevor's personal allowance for 2015/16 is set first against his pension and his property income and so neither of these will be taxable. All of Trevor's taxable income is savings income. The first £5,000 will be charged at the new starting rate for savings of 0% and the balance will be taxed at the basic rate of 20%.

| | | £ |
|---|---|---|
| 5,000 @ 0% | | – |
| 700 @ 20% | | 140 |
| | | 140 |
| Less: | Tax deducted at source (20% x 6,000) | 1,200 |
| REPAYMENT DUE | | £(1,060) |

If the 2014/15 starting rate and limit had still applied to Trevor's 2015/16 income, his tax position would have been:

| | | £ |
|---|---|---|
| 2,880 @ 10% | | 288 |
| 2,820 @ 20% | | 564 |
| | | 852 |
| Less: | Tax deducted at source (20% x 6,000) | 1,200 |
| REPAYMENT DUE | | £(348) |

This represents a tax difference of £1,060 – £348 = £712.

*Contributed by Robert Jamieson*

# Capital Taxes

## Scrip dividends and the 10 year charge on discretionary trusts

The UT held that the 10 year charge (payable under IHTA 1984 s 64) by a discretionary trust was payable in relation to the proceeds of sale of ordinary shares issued by way of scrip dividend.

The issue was whether the proceeds of sale were 'income' for trust law purposes. If they were, they could not be part of the 'relevant property' (IHTA 1984 s 58) for the purpose of section 64, and therefore escaped the charge. Whether the proceeds were 'income' in turn depended on whether ICTA 1988 s 249(6) deemed the scrip dividend shares to be trust income as a matter of general trust law.

*Decision:*

Referring to the Court of Appeal's decision in Howell v Trippier [2004] EWCA Civ 885, the UT noted that the question was whether the 'clothing of the actual shares as notional trust income' was a fiction which applied for ICTA 1988 s 686(2)(a) purposes only or for general trust purposes. The UT considered that 'the correct approach to deeming provisions did not permit the fiction in s 249(6) to be extended to general trust law'. In particular, there was no suggestion in the text of the provision that its deeming effect extended to statutes beyond ICTA 1988, which is a taxing statute and cannot therefore override the terms of a trust without clear words to that effect. The trustees had originally thought that the scrip dividends were income. They had therefore filed the trust's tax return on that basis and paid the 10 year charge by reference to trust assets, including the scrip dividend shares. However, following the decision of the High Court in Pierce v Wood [2009] EWHC 3225 — which held that 's 249(6)(b) of the Taxes Act is to be construed as treating a scrip dividend received by trustees as income in their hands for the purposes of trust law' — the trustees had formed the view that the proceeds of sale of the scrip dividend shares were income and that they were therefore entitled to a repayment. HMRC had turned down their claim and the trustees were appealing against HMRC's decision. The UT therefore also had to decide whether it was bound by Pierce v Wood. The UT considered that Pierce v Wood had been wrongly decided and that, as a superior court of record (under TCEA 2007), the UT was not bound by decisions of the High Court. This conclusion was not displaced by the Supreme Court's decision in Cart [2012] 1 AC 663. The question of whether the High Court has supervisory jurisdiction, as a matter of judicial review, over unappealable decisions of the UT is conceptually distinct from the question of whether decisions of the High Court are binding on the UT.

**Comments -** Beyond the technical point in issue, the analysis of the interaction between taxing provisions and general trust law could be relevant to different circumstances. The fact that the UT is not bound by decisions of the High Court is also worth noting.

*JP Gilchrist v HMRC (FTC/89/201)*

## EIS and taper combo

In 2005/06, the taxpayer sold some properties. Two had been used for business and non-business purposes, others had been used for business only or non-business only. The taxpayer claimed enterprise investment scheme relief and asked that it be divided between the gains on the non-business properties and the non-business parts of the mixed-use assets. He wished to apply EIS relief against the full amounts of the non-business gains on the two mixed-use properties, and apply taper relief to the remaining business gains, after the balance of the EIS relief was used.

HMRC said that EIS relief could be used only against the whole gain of a single asset and it could not be apportioned in the way proposed by the taxpayer.

The First-tier Tribunal allowed the taxpayer's appeal. The Revenue appealed.

*Decision:*

The Upper Tribunal said the First-tier Tribunal was wrong to decide that the deeming provisions in TCGA 1992, Sch A1 para 3 and 9 for taper relief also applied to EIS relief. These provisions appeared in a schedule concerned solely with taper relief and there was no justification to give them wider application.

The judge said the First-tier Tribunal accepted the taxpayer's submission that, because he wished to allocate EIS relief to the non-business part of the gain to make the best use of taper relief, the allocation was made for taper relief purposes. He said:

“With respect to the tribunal, the issue is not the purpose of the taxpayer in seeking to make this election but the purpose of the legislative provisions. The issue is whether there is anything in the legislation which deems for the purposes of EIS relief the gain on the disposal of a single mixed-use asset to be two separate gains. In my judgment, there is not…”

HMRC's appeal was allowed.

**Comments –** This case is now of historic interest but it demonstrates how the rules in relation to apportionment need to be adhered to ensure the correct application of the relief.

*CRC v Stolkin, Upper Tribunal*

# Administration

## Direct Recovery Of Debts

A consultation document 'Direct Recovery of Debt' has been published which describes a new power which will allow HMRC to recover debts from the accounts of debtors who are able to pay what they owe but have chosen not to do so, and have not responded to HMRC's attempts to contact them and collect these sums.

*Initial identification of suitable cases*
The debts will only be suitable for direct recovery of debts (DRD) where there is a tax or tax credit debt of £1,000 or more due to HMRC. This £1,000 amount could be owed under just one tax or could be made up from smaller debts owed across a range of taxes. It will also include NICs.

Examples of the types of debt that will be covered by DRD include, but are not limited to:
- tax debt owed by individuals (for examples, income tax or VAT);
- tax credit debt owed by individuals who have received overpayments of tax credits (for example, Child Tax Credit or Working Tax Credit) and need to repay them; and
- taxes owed by businesses and partnerships (for example, unpaid corporation tax and PAYE tax).

Before getting to the stage where DRD is applied, a debtor in self-assessment who has a good history of compliance will typically have been contacted by HMRC approximately nine times (including by letter and telephone). At a minimum, they will have been contacted four times. If the debtor has always been compliant in the past, they are likely to be contacted more times before enforcement is used (compared to a debtor with a history of non-compliance).

At any stage in this process, the debtor can contact HMRC to pay in full, agree a Time to Pay arrangement, or query the amount they owe. If the debtor does not agree with the amount of tax that is due, they have a right to appeal to a Tribunal.

Once a debt is suitable for DRD action to be used, HMRC will match this debt against the bank, building society and ISA account information it already holds. Banks and building societies and other deposit takers are already required to share information with HMRC about interest paid or credited to accounts they hold for their customers. DRD will therefore only be considered in specific cases where a clear match is found, based on HMRC's existing data. The consultation document sates that "rigorous internal checks will be undertaken to ensure that HMRC has up to date information from banks about a debtor's account and that the debt is still due.

*Contacting the debtor's bank/building society*
Once HMRC has established that the debtor has funds in their accounts, it will contact the relevant deposit taker. HMRC will request information about all the debtor's accounts, including current and savings accounts and ISAs, along with current balances and details of transactions within a specified period. This will supplement the data HMRC already holds on interest-bearing accounts.

This information is required so that HMRC can determine how much money should be held, and ensures that HMRC does not put a hold on money that will be required by the debtor to pay upcoming wages, mortgages or other essential business or household expenses.

HMRC is proposing to ask the deposit taker for 12 months of past account information on the debtor. This will allow HMRC to see any patterns in the debtor's account history, including any seasonality (such as monthly or annual bill payments). This will ensure that HMRC does not inadvertently cause hardship for the debtor when applying DRD to those accounts. HMRC believes that 12 months of information strikes a sensible balance between ensuring HMRC has accurate information while maintaining the debtor's privacy.

HMRC is proposing that the deposit taker should be required to supply this information within five working days. This balances the need to ensure HMRC has up to date information on the debtor with the administration this will require from the deposit taker.

*Deciding how much to recover*

HMRC will not use DRD if the information shows that the combined credit balances of the accounts concerned are less than £5,000. In cases where the debtor has accounts at more than one institution, HMRC will draw upon information from all relevant deposit takers. HMRC would only seek access to positive balances and will not create or increase overdrafts.

Where the balance is over £5,000, HMRC will analyse the account information supplied by the deposit taker in order to estimate the minimum level of funds that need to be left in the accounts to enable the taxpayer to meet necessary day-to-day domestic expenses. HMRC would exercise the same judgement in doing this as it currently uses when deciding whether to seek a third party debt order in England and Wales.

Where there is evidence that a business account is being used for trading – for example, the payment of regular costs such as employee wages – HMRC will take this into consideration. In most cases, HMRC will look to prioritise recovering debt from accounts that appear to be used primarily for savings over those that appear to be used for day-to-day expenses. HMRC will protect sufficient funds within the account to cover those expenses.

In all cases, HMRC will ensure that a minimum credit balance of £5,000 is available to the debtor across all accounts after the debt has been recovered. HMRC claims that a minimum balance of £5,000 goes far beyond the international norm, in countries where the tax authorities have similar powers to DRD.

*Instructing the bank/ building society to hold funds*

Where HMRC identifies that there is a suitable account (and that sufficient funds are available after considering upcoming essential expenses) the deposit taker will be instructed to hold funds up to the value of the debt. HMRC will usually seek to collect the debt in a single lump sum. Where there are insufficient funds in the account(s) to immediately meet the full value of the debt (but analysis of account information suggests that regular deductions could be made), HMRC will seek payment by instalments.

*Notifying the debtor*

Once the deposit taker has placed a hold on the debtor's funds, HMRC will write to the debtor to inform them of the action it has taken. If the debt is to be recovered by instalments, the letter will include full details of all the payments that will be taken from their account. The deposit taker will also be asked to contact the debtor, repeating the details of how to get in touch with HMRC.

Debtors will have 14 calendar days from the date of the letter notifying them of the held funds to either pay by other means (e.g. full settlement of the debt or, in appropriate circumstances, via a Time to Pay arrangement) or to object or provide evidence of hardship. During this period, no funds will be transferred to HMRC.

HMRC believes that 14 calendar days is a suitable period of time for the debtor to arrange payment once the funds have been held. Before reaching this stage, the debtor will have been contacted multiple times by HMRC and, in HMRC's view, will have had ample opportunity to get in touch to arrange payment.

*Helpline*

A dedicated telephone line will be available for debtors to contact the DRD team and arrange alternative payment or to object. This phone number will be included in the notification letter sent to debtors when DRD action is taken. It will also be provided to the deposit taker who is holding the funds for HMRC, in case the debtor attempts to query the decision through their bank or building society.

If debtors believe they have been incorrectly targeted, the funds are not theirs or they believe the use of DRD will cause hardship, they will be able to contact HMRC via this helpline and discuss their individual case.

*Debtor objections and right of appeal*

The debtor will have several means of contesting the use of DRD:

- Before DRD is applied, the debtor will usually have the option of appealing to the First-Tier Tax Tribunal on the amount of tax due or on the legal basis of the liability.
- Once DRD has been applied, if the debtor objects and provides evidence to HMRC's satisfaction that DRD action will cause undue hardship or that the debt is no longer due, HMRC will instruct the deposit taker to immediately release the held funds back to the account holder.
- If the debtor objects and HMRC does not uphold the debtor's objection, they will continue to have the right to judicial appeal on the use of DRD.

*Recovery action*

If during the 14 day period the debtor pays by other means or agrees a Time to Pay arrangement with HMRC, the deposit taker will be notified to release the held funds back to the account holder.

If, at the end of the 14 calendar days, the debtor has not paid by other means or contacted HMRC to make an objection which is later upheld, the deposit taker will be instructed to transfer the held amount to clear all or part of the debt. In the case of instalments, the bank will be instructed to transfer the first instalment to HMRC and make further transfers until the debt is cleared.

*Joint Accounts*
Where a debtor holds a joint account, HMRC proposes that a pro-rata proportion of the credit balance will be subject to DRD. For example, where the debtor holds an account with another person, 50% of the credit balance could be used to pay the debt. HMRC also proposes that joint account holders who do not owe money to HMRC should have the right to object to the recovery of debts from their joint account on the grounds of hardship or misidentification. Where a hold is placed on a joint account, all the account holders will be notified that this action has been taken and will have the opportunity to object to the DRD notice, to the same timeframes as described above.

## Proceedings in front of tax tribunals after judicial review

The FTT granted HMRC its application to have the case struck out.

Both appellants had entered into tax planning structures to shelter UK income from income tax, using an exemption under the UK/Isle of Man double tax treaty. Relying on ITTOIA 2005 s 858 (introduced with retrospective effect by FA 2008 s 58), HMRC had issued closure notices for the tax years 2005/06, 2006/07 and 2007/08, on the basis that the claimed exemption no longer applied. Both appellants started proceedings for judicial review of HMRC's decision, principally on the ground that the retrospective effect of s 58 was in breach of the European law principle of free movement of capital (TFEU art 56). The Court of Appeal dismissed the taxpayers' application for judicial review, on the grounds that there had been no actual movement of capital and that the retrospective effect of s 58 was proportionate and compatible with ECHR art 1. The Supreme Court subsequently refused permission for an onward appeal and the appellants sought to start litigation in front of the tax tribunals.

*Decision:*

The tribunal held that the decision of the Court of Appeal was not res judicata on the taxpayers' art 56 argument. An appeal against an income tax assessment was sufficiently different from judicial review proceedings so as not to be prevented by cause of action estoppel and the parties to the proceedings were technically not the same. However, the tribunal also considered that the decision of the Court of Appeal was stare decisis. The Court of Appeal had found that s 56 was not engaged, as the scheme had not involved any movement of capital. This decision on a point of law was binding on the tribunal. Finally, the appellant's argument per incuriam that the Court of Appeal had considered neither relevant ECJ case law nor the relevant facts was robustly rejected. The FTT referred in particular to the wording of the Supreme Court when refusing leave to appeal: 'in relation to the point of European Community law raised in the application, the application is also refused because the correct application of Community law is so obvious as to leave no scope for reasonable doubt'. The taxpayers had put forward the evidence they wished to rely upon to the Court of Appeal. Referring to Johnson v Gore Wood [2001] 1 All ER 481, the tribunal concluded that allowing the art 56 point to stand would be an abuse of process.

**Comments -** This decision puts an end to a judicial saga which has spanned six years, affected many taxpayers and was caused by the controversial retrospective effect of FA 2008 s 58. Taxpayers faced with a decision of HMRC they disagree with are often faced with the difficult choice between an appeal in front of the tax tribunals and judicial review proceedings. This case suggests that once judicial review proceedings have reached their conclusion, there will often be no going back.

*Shiner & Sheinman v HMRC TC3505*

## Cost allocation: group loses appeal

The tribunal had to decide the correct allocation of costs in circumstances where only some of the appellant companies (all members of the same group) had lost their appeal. The appeals were lead cases in relation to a scheme entered into by a number of corporate groups.

The scheme was designed to achieve a corporation tax deduction in one group company ('the borrower') for the costs of an intra-group borrowing, but without any concomitant taxable accrual or receipt in the group company making the loan ('the lender'), or in the group company which received an amount of preference shares issued by the borrower equivalent to interest on the loan ('the share recipient'). The scheme would therefore achieve its tax objective only if the borrower was entitled to a tax deduction, and neither the lender nor the share recipient was taxable on the corresponding amount. HMRC had challenged the scheme on all fronts, disallowing the interest deduction for the borrower and contending that either the lender or the share recipient was taxable.

*Decision:*

The FTT had allowed the appeals of the lender and the borrower, but dismissed the appeal of the share recipient. The case had been categorised as complex and so HMRC, being the successful party overall, applied for costs. The taxpayers argued that they should only have to pay HMRC's costs in respect of the appeal by the share recipient, as it was the only appeal in respect of which HMRC had been successful. The tribunal observed that the taxpayers' attempt to elevate 'success' to this level of technicality was not consistent with the overriding objective of fairness and justice. Referring to Lloyds Underwriters [2008] 3 Costs LR 427, the FTT emphasised that having regard to 'the litigation as a whole, and looking at the position in a realistic and commercially sensible way', the scheme had failed. The tribunal also rejected the appellants' contention that HMRC had acted unreasonably against the borrower and the lender, noting that there is 'no automatic rule requiring reduction of a successful party's costs if he loses on one or more issues'. However, in relation to the borrower, the tribunal did accept that the appeal was discrete, in that it did not depend on the outcome of the other appeals. The borrower should therefore be entitled to the recovery of its costs. The position was different for the lender issue, as it was argued in the alternative to the share recipient issue, and so, the appeals in respect of both the lender and the share recipient should be treated as a single appeal in which HMRC was successful. HMRC was therefore entitled to recover its costs in respect of both appeals. Finally, and as there were multiple defendants, the tribunal also had to decide whether a Bullock [1907] 1 KB 264 order or a Sanderson [1903] 2 KB 533 order would be appropriate. Under a Bullock order, the costs of a successful defendant are added to the costs which the claimant is entitled to recover from the unsuccessful defendant. Under a Sanderson order, the costs of a successful defendant are paid directly by the unsuccessful defendant. The tribunal decided that there was no basis for it to exercise its discretion to make either of these orders. The fact that the claim against the borrower was not put in the alternative was a material factor, as was the fact that the claim was independent. HMRC should therefore pay the borrower's costs.

**Comments -** The taxpayers' application for costs was a bold move in circumstances where the tribunal had unequivocally held that their scheme had failed. Even when a scheme fails, not all parties to the scheme are necessarily losers when it comes to deciding the cost allocation.

*Versteegh v HMRC TC3526*

## UK's action against FTT fails

The CJEU dismissed the UK's action against the decision of the European Council authorising 11 member states to establish enhanced cooperation between themselves in order to set up a common financial transaction tax (FTT). The decision of the Council was reached after it became obvious that it would not be possible to achieve unanimous support for the principle of a common system of FTT.

The UK contended that the decision would produce extraterritorial effects (in breach of TFEU art 327) and that it would impose costs on non-participating member states (in breach of TFEU art 332).

*Decision:*

The court found that the Council's decision was limited to authorising the establishment of enhanced cooperation. As such, it did not contain any substantive element on the FTT; nor did it contain any provision on the issue of expenditure linked to the implementation of enhanced cooperation. The CJEU therefore dismissed the UK's action.

**Comments -** This action was clearly a precautionary measure for the UK, which is likely to challenge the implementing measures adopted by each of the participating states.

*United Kingdom v Council of the EU (C-209/13)*

## Lead cases: what should happen when the lead case loses and does not appeal?

A case direction specified Nuffield Health [2013] UKFTT 291 as the lead case and scheduled the related cases, including this appeal, which were stayed in accordance with Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules, SI 2009/271, (the 'FTT rules'), rule 18(2).

The tribunal dismissed Nuffield's appeal. This left General Healthcare (GH) in a difficult position, as it considered the decision to be wrong; however, Nuffield was not going to appeal and several factual issues which concerned GH's case had not been decided in Nuffield. GH argued that the proper course was not for its case to proceed by way of appeal to the UT — as the UT would have to rely on the facts as found by the FTT in Nuffield — but rather to 'unbind' GH from Nuffield under rule 18(4). The tribunal noted that the 'common or related issues' set out in the lead case direction were confined to issues of law and so Nuffield was only binding on issues of law. The Nuffield decision could therefore be treated as a decision on a preliminary issue of law. Consequently, a challenge to the Nuffield decision could only take place by way of appeal to the UT. The UT could then determine GH's appeal relying on GH's factual assertions and remit the case to the FTT for further findings of fact if necessary. The UT may therefore come to different conclusions. The tribunal stressed that rule 18 did not allow a party to a related case to appeal the decision in the lead case even if, as suggested by GH's counsel, the lead case was wrongly decided as a matter of EU law.

**Comments -** Practice directions nominating a lead case are rather common in tax, for instance where several taxpayers have implemented the same scheme. The case therefore helpfully sets out the applicable procedure when the lead case fails in the FTT and does not appeal, but a related case wishes to appeal.

*General Healthcare v HMRC TC3488*

## Benefit of the doubt on reasonable excuse

The taxpayer was a partner in a firm of solicitors, Gordon Brown Associates. His share of the profits for the year to 30 April 2010 was £125,848 and he included this sum in his 2010/11 self-assessment tax return.

In February 2011, a limited liability partnership, Gordon Brown Law Firm, was formed. There were no profits for the period to 5 April 2011 and the taxpayer did not refer to the LLP in the 2010/11 return. His tax for the year was £40,029, due on 31 January 2012. On 28 February, the taxpayer called HMRC to discuss payment and said he would pay on 26 March.

He failed to pay on that date and HMRC imposed a surcharge at 5% of the tax outstanding.

The taxpayer said he understood from the conversation that the 26 March deadline had been a provisional arrangement and he thought HMRC had allowed him time to pay more generally. HMRC said the payment had been deferred until 26 March by way of a “payment promise”. By not paying on that date the taxpayer had broken the arrangement.

The taxpayer appealed saying he had reasonable excuse for the late payment.

*Decision:*

The First-tier Tribunal said the telephone conversation of 28 February 2012 was “crucial to the outcome of the case”. The taxpayer, exercising reasonable foresight and due diligence, realised that he would be unable to pay his tax on time and contacted HMRC. The HMRC officer did not agree a time to pay arrangement, a payment plan or mention that a penalty would be imposed if payment was not made by that date. The position was therefore unclear, but he believed the deadline for payment was extended by HMRC to 26 March 2012 and that, if necessary, it would be reviewed then.

The tribunal concluded that the taxpayer thought “not unreasonably that he was being given time to pay without penalty”.

The taxpayer's appeal was allowed.

**Comments -** The First-tier Tribunal said the telephone conversation of 28 February 2012 was “crucial to the outcome of the case”. This case is yet another where the quality of the record keeping is essential to the success of the argument over reasonable excuse. Although record keeping should be second nature to such a professional many of these cases have demonstrated that the Tribunal will take a more beneficial attitude when the taxpayer can back up their arguments with appropriate information.

*G Brown v HMRC TC3348*

## Taxpayer is responsible

The taxpayer was a firm of chartered accountants which appealed against penalties imposed under FA 2009, Sch 56 for making late payments of PAYE during 2011/12.

The firm claimed special circumstances, saying that, since 2008, it had helped clients through the difficult economic period, sometimes on a non-commercial basis. It was under financial pressure, on one occasion barely having enough cash in the bank to pay its staff. In January 2010, the firm lost two major clients which between them had accounted for 20% of its business. The firm also had to deal with staff illness and fee-earners leaving the business. However, by spring 2012 it had become more viable and business had improved.

On its PAYE obligations, the firm had amassed a debt of £44,000 for 2010/11 and wanted to repay this in the first four months of 2011. There was a lot of contact between the firm and HMRC during the period from April 2009 to July 2012, which included time-to-pay arrangements, promises of payment, explanations for non-payment and threats of distraint. The taxpayer believed, and the tribunal accepted, that it had allocated payments made during the period 3 May 2011 to 1 July 2011 to the 2010/11 liabilities.

The taxpayer argued that, given the personal sacrifices the director had to make to ensure the business remained a going concern, HMRC should not impose penalties, because these would “simply make future compliance more difficult”.

*Decision:*

The tribunal said this was not consistent with the scheme of Sch 56, and the penalties in point were not disproportionate. However, “special circumstances” did not include “ability to pay”. The inability to pay fell within reasonable excuse, but only if it could be attributed to matters beyond the taxpayer's control. This was not the case for the taxpayer.

On allocation of payments, the tribunal said it did not consider HMRC had “any duty to advise a taxpayer as to the most beneficial allocation”. The taxpayer, which the tribunal emphasised was a firm of chartered accountants, should take responsibility for its own actions. HMRC had warned the taxpayer in February 2010 that defaults could lead to penalties. The tribunal said HMRC had not “in any way” let the firm down.

There were no special circumstances: the taxpayer was in financial difficulties but it was aware of the penalty regime and should have addressed its position accordingly.

The taxpayer's appeal was dismissed.

**Comments -** There were no special circumstances: the taxpayer was in financial difficulties but it was aware of the penalty regime and should have addressed its position accordingly. The statement is self explanatory.

*Knowles Warwick Ltd v HMRC TC3362*

## Distress is no excuse

The taxpayer was late paying his self-assessment tax for 2009/10 and for 2011/12, so HMRC imposed surcharges on the outstanding amount.

The taxpayer appealed. He said he had been working for a person in public life which entailed long hours. He had also been distressed by various family and friend bereavements and tragedies. He subsequently lost his job, and was unable to pay the tax due. He said HMRC had not been helpful although they had now given him to time to pay.

*Decision:*

The First-tier Tribunal said it appreciated the taxpayer had been through some difficult times, but he had not produced medical evidence to support his claims of stress. While he must have been upset, the tribunal could not believe that the distress prevented him finding the time to deal with his tax affairs. It noted that he had experience of how the tax system operated so was aware of his obligations.

The taxpayer's appeal was dismissed.

**Comments –** The result is not surprising given the circumstances but could be seen to be lacking in sympathy.

*Alan Hamilton v HMRC TC3370*

## Trial was not unfair

In February 2013, the defendant, a barrister, was found guilty of failing to account for the VAT charged on his fees and was jailed for three-and-a-half years. He applied for leave to appeal against his conviction claiming that at the trial the prosecution produced documents that he was unaware of and the judge's summing-up was unfair and defective.

In September 2011, two HMRC officers visited the defendant's home to deliver a letter asking him to attend a police station interview in relation to his failure to pay VAT. One of the officers made a note that the defendant read the letter and then said "it's fine". The note was not produced at the interview two weeks later where the defendant said that he had been shocked when he read the letter.

At the trial, the defendant said he believed that the VAT was being paid on his behalf by his chambers and that he was horrified to find out that it had not been paid. Counsel for the prosecution asked him why he had not reacted this way when first approached by the officers, to which the defendant replied "nonsense" and did not recall saying "it's fine". As a result of that response, the prosecution considered the disclosure of the note made by the visiting HMRC officers was relevant.

The defendant said he had not known the note would be used at the trial. Further, he had been given no opportunity to sign the note as being correct.

He also said that the prosecution should not have cross-examined him about his divorce settlement because this happened after the VAT issue.

*Decision:*

The Court of Appeal judge said it was appropriate for the prosecution to use the note. It showed a contrast between the defendant's initial reaction and what he had said in his interview and in his evidence at trial. However, because what the defendant had said in interview had been no different from what he had said at the trial, it was difficult to accept the prosecution's submission that it became relevant only when the defendant gave evidence.

The important point was the fact that the defendant had not told the investigators that his VAT had been paid by his chambers and that there had been a terrible mistake. Furthermore, he had not taken any immediate steps after the initial visit to contact his chambers and confirm the position. For these reasons, although the prosecution had not acted correctly, the error on its part had no material effect on the fairness of the trial or on the safety of the conviction.

On the divorce settlement, the judge said the criminal court judge should have directed the jury as to its relevance rather than leaving it for the jury members to decide: namely, if it showed that the defendant had acted dishonestly in 2012, was this relevant to the offence with which he had been charged?

Finally, on the judge's summing up, the Appeal Court judge said:

"[it] was open to material criticism for the way in which it was constructed and the inaccuracies it contained. This court does not expect a judge in this day and age to deliver a summing up in a case such as this which was not properly prepared and which fails to set out the evidence in a manner which was helpful to the jury."

However, criticism of the summing-up did not render the conviction unsafe. It contained directions of law, which were correct, and a summary of the evidence, which, "although woefully organised and inaccurate in some respects", had not been "significantly inaccurate" or unfair.

The application for leave to appeal was refused.

**Comments –** This case raises some interesting points on the procedures when being charged with a potential crime which may result in incarceration. It would be expected that a barrister would have a better appreciation of the relevant responses. Having said that there were a number of deficiencies in the case that the judge referred to and the summing up should be noted.

*R v Pershad, Court of Appeal*

## PAYE for employers: in-year interest on late payments

**Important information on how to avoid late payment interest and what to expect if a 2014 to 2015 PAYE or CIS payment is late**

HMRC now charges interest on any late PAYE and Construction Industry Scheme (CIS) payments. For employers that pay monthly, the first payment of 2014 to 2015 is due on 19 May (or 22 May for employers who pay electronically).

To avoid an interest charge employers should pay by the due date, the difference between the following:

- what they report on their Full Payment Submission(s) (FPS) received by the 19th of the month following the end of the tax month it relates to, together with any CIS charges for that tax month
- any deductions reported on an Employer Payment Submission (EPS), again received by the 19th of the month following the end of the tax month it relates to

If employers make a correction on an FPS that HMRC receives after the 19th of the month following the end of the tax month it relates to, the correction will be included in the following month’s charge. In these circumstances, the amount payable for the tax month is the amount actually reported by the 19th (rather than the corrected amount).

<u>Interest Charges</u>

HMRC will charge interest on all unpaid:

- PAYE tax, Class 1 National Insurance and Student Loan deductions, including specified charges (estimates HMRC makes in the absence of a PAYE submission)
- Construction Industry Scheme charges
- In-year late filing penalties, which start from October 2014
- In-year late payment penalties, which will be charged automatically from April 2015

HMRC will charge interest daily, from the date a payment is due and payable to the date it is paid in full.

<u>Accruing Interest and the Business Tax Dashboard</u>

Employers will be able to see an estimate of the interest building up on the Business Tax Dashboard.

Please note that:

- Accrued interest is only a guide to what may be due. HMRC will only seek payment of interest when the amount due is settled.
- The Business Tax Dashboard will only show interest as accruing in the current month, regardless of when the payment was due.
- It will show interest as accruing from the 19th of each month, regardless of how the employer pays. Employers who pay electronically should not worry if they see an accrued interest entry between 19th and 22nd of a month. Once the electronic payment is received, the calculation will correctly use the 22nd as the due date, and any interest charge generated between the 19th and 22nd will be cancelled.

Currently, there is an HMRC systems error which results in the Business Tax Dashboard showing interest accruing despite the employer having submitted an EPS that clears the original charges. This error will be corrected shortly. In the meantime, HMRC will not pursue this charge and employers do not need to contact HMRC about this.

## Unreasonable request

The taxpayer, a GP who also has a private practice, discovered an error in her 2010/11 self-assessment tax return after HMRC opened an enquiry into it. She explained what had happened in a meeting with HMRC. The officer subsequently wrote to the taxpayer requesting further information under FA 2008, Sch 36 para 1, including her business appointment diaries.

The taxpayer refused, saying the diaries contained confidential patient information and no financial information.

*Decision:*

The First-tier Tribunal said the taxpayer was “wholly credible and reliable”. She had co-operated with HMRC, answering their queries. The judge could not see that the diaries would be of any use to HMRC because they contained no financial information and were not necessarily an accurate record of patients seen and charged. He concluded from the taxpayer's evidence that HMRC's requirement was unreasonable, and the taxpayer's appeal would succeed on this issue alone.

On the confidentiality issue, the judge chose not to make a decision but said he “inclined to the view that, in certain circumstances, the statutory provision … in Sch 36 will prevail over the duty of confidentiality”. The taxpayer's appeal was allowed.

**Comments –** This case is a very good demonstration that although HMRC have extensive powers of inspection post the merger in Finance Acts 2007, 2008 and following there are limits to what they do. As the First-tier Tribunal said the taxpayer was “wholly credible and reliable” and other factors they found the HMRC request unreasonable.

*Dr K Long v HMRC TC3339*

## Costs against HMRC awarded

The taxpayer was late paying his self-assessment tax. He claimed reasonable excuse saying his wife had fallen gravely ill between the end of January and the middle of February, requiring major surgery, and he had to care for her during this time. At first, HMRC refused to accept that the taxpayer had a reasonable excuse and the matter was listed for hearing before the First-tier Tribunal. However, before the appeal was heard, HMRC accepted there was a reasonable excuse and the appeal was cancelled. The taxpayer claimed the costs of preparing for the cancelled appeal hearing, saying HMRC had acted unreasonably. The amount claimed was £2,000, calculated at 42 hours at about £50 an hour.

*Decision:*

The First-tier Tribunal noted that HMRC have “always maintained that … to claim a reasonable excuse the taxpayer would have to show something exceptional prevented compliance with the rules, such as an unexpected serious illness”. The tribunal said the wife's illness clearly fell into that category. However, despite holding the relevant information, HMRC denied the excuse, going against their own guidance.

The tribunal judge decided that HMRC had acted unreasonably and could have reached their final conclusion several months before they finally did.

In deciding that costs should be allowed, the tribunal said that 42 hours was excessive and ruled that ten hours at £18 an hour was a reasonable amount.

The taxpayer's appeal was allowed and costs of £180 awarded.

**Comments –** There are different costs that can be applied for and in this one the taxpayer was not arguing that HMRC had acted wholly unreasonably but was seeking to recover his costs. The Tribunal found that HMRC had acted unreasonably and therefore costs would be awarded but not at the level the taxpayer was seeking.

*N Bogle vHMRC TC3341*

## Whether negligently delivering return

The FTT held that the taxpayers, who had implemented a tax scheme, had not completed their tax returns negligently.

In 2005, the taxpayers had entered into a marketed tax avoidance scheme with a view to sheltering chargeable gains realised on the disposal of shares in a company. The scheme involved generating capital losses on the acquisition and disposal of capital redemption policies. They had disclosed the scheme in their tax returns for 2005/06, which were delivered in January 2007. HMRC had opened an enquiry into the returns. Following the Court of Appeal's finding in Drummond [2009] EWCA Civ 608 that the scheme was ineffective, the taxpayers had paid the tax due and the enquiry was closed. HMRC argued that the returns had been delivered negligently as a result of the incorrect implementation of the scheme and that a penalty was due. Both parties accepted that the preliminary issue was whether HMRC had adduced evidence from which the tribunal could prima facie be satisfied that the taxpayers had negligently delivered incorrect tax returns. HMRC contended that the taxpayers had signed documents which were either not authentic or misrepresented the reality.

*Decision:*

However, the FTT pointed out that such documents had been unilateral documents signed by the promoter of the scheme only. The allegation of the statement of case was to the effect that 'a reasonable person, having examined “the documentation” would have realised that the scheme had not been properly implemented'. The FTT observed that the allegation of negligence should have been particularised and HMRC had failed to establish a prima facie case of negligence. The appeal was therefore allowed.

**Comments -** The fact that the taxpayers had not asked to see documents to satisfy themselves that the scheme had been properly implemented could amount to negligence. HMRC only lost because it had failed to articulate this point clearly in its statement of case.

*Ryan Gardiner and others v HMRC TC3550*

## Adequate information provided

HMRC issued information notices under FA 2008, Sch 36 to several banks and a firm of accountants (Lubbock Fine LLP) in respect of their clients after a request from the Australian Tax Office. The ATO was investigating an avoidance scheme involving companies in foreign jurisdictions, including the UK, beneficially owned by Australian residents and used by them to avoid tax. The Australian investigation showed that Lubbock Fine was providing nominee directors and shareholders to the UK companies involved in the arrangements. Unable to obtain details from the Australian resident taxpayers, the ATO wanted to obtain that information from third parties in the UK.

The claimants were 24 of the companies whose documents were sought by HMRC for the investigation. Only three of those were considered “taxpayers” by HMRC for the purposes of Sch 36 para 3(3)(e) and were provided with a summary of the reasons for the notices. The other companies were not considered as taxpayers. They therefore had not received any explanation as to why HMRC required the information or been given the opportunity to object to disclosure.

The claimants said that the notices were invalid because no explanation had been provided to the 21 claimants who were not treated as taxpayers and also because the reasons given to the other three claimants were inadequate.

*Decision:*

The High Court said the fact that a notice referred to a person in a Sch 36 notice did not require that person to be the subject of a tax enquiry. Only if the subject of the notice was also the taxpayer who was the direct focus of the notice, ie the information was required to check his tax affairs, did the legislation state he was entitled to a reason why the information was needed. In the instant case, the 21 claimants were not taxpayers because their tax affairs were not under enquiry and therefore they were not entitled to an explanation.

On the alleged inadequacy of the reasons provided to the three taxpayer claimants, the judge disagreed. She said the letters contained sufficient detail and did not have to specify the documents sought.

The application was dismissed.

**Comments –** Schedule 36 has specific powers and therefore specific conditions attached. This case demonstrates that HMRC complied with those conditions and accordingly as the letters contained sufficient detail the appeal was dismissed.

*R (on the application of Derrin Brother Properties Ltd) v CRC, QBD*

## Muddled details

HMRC imposed penalties on the taxpayer for the late submission of its 2012/13 annual employer return. The Revenue rang the taxpayer in the same month to advise it that the returns for 2010/11, 2011/12 and 2012/13 had not been received and the total penalties outstanding were £2,400. The 2012/13 return was filed in September 2013.

The taxpayer appealed against the 2012/13 penalties only — mainly because it had not received any penalty notices for the earlier years. The representative for the taxpayer said it had two other businesses and the book-keeper had filed the returns for all three at the same time. He questioned why it had taken HMRC so long to say the earlier returns had not been received. He said he had had many telephone conversations with HMRC who agreed that the error had arisen at the department.

HMRC said the taxpayer had made only one call, but the taxpayer produced telephone records to show ten calls from a business landline lasting 142 minutes in total and calls from personal numbers.

*Decision:*

The First-tier Tribunal was “concerned at the attitude of HMRC”. The judge was unable to say whether the fault for the problem in submitting the return lay in the taxpayer's or HMRC's systems. But she accepted the taxpayer had made many calls and taken “all reasonable steps to rectify the situation”. HMRC did not explain why they had delayed for so long in dealing with the failure of the taxpayer to submit the returns. This led the judge to consider the problem was HMRC's fault. She said: “The whole situation ought to have been investigated and explained.”

Given the Revenue's failure to explain events, she said the taxpayer had established reasonable excuse and allowed the appeal.

**Comments –** As commented upon with many cases a taxpayer’s case is always assisted by detailed record keeping when HMRC allege certain facts or behaviour. The sentence highlighting HMRC said the taxpayer had made only one call, but the taxpayer produced telephone records to show ten calls from a business landline lasting 142 minutes in total and calls from personal numbers tells its own story. The comments in the decision are worthy of note.

*Hogg Joinery Ltd (TC3425)*

## Employer provided no evidence

The Mothers' Union was found to have operated the wrong PAYE code for one of its employees. As a result, the employee underpaid tax. HMRC issued a determination to collect the tax from the taxpayer. It appealed, claiming that it had not received an email providing the correct code from HMRC.

*Decision:*

The First-tier Tribunal noted that when an employer registered for online filing, it accepted that communications would be conducted electronically unless it opted out.

The taxpayer agreed this to be true but said it had had problems with its systems and had not received the email with the employee's code.

The judge said that, according to the Application of Income Tax (PAYE) Regulations, reg 196(1)(b), the burden of proof of non-delivery lay with the taxpayer.

The employer was responsible for using the correct code and, because it offered no evidence that the notice had not been delivered, it was liable to pay the tax.

The taxpayer's appeal was dismissed.

**Comments –** The decision is self-explanatory and not surprising.

*The Mothers' Union (TC3414)*

## No paper allowed

The director of the taxpayer submitted the annual employer return for 2010/11 on paper because he did not have access to the internet at the time. HMRC imposed penalties under TMA 1970, s 98A on the basis that no online return had been received. On 6 December 2011, the taxpayer submitted the return electronically and appealed against the penalties.

*Decision:*

The First-tier Tribunal said the director had not provided a satisfactory reason as to why he had no internet access to submit the return by the due date and noted that the relevant return had been filed online in the previous year. The judge said a paper return was not valid for the purposes of the Income

Tax Regulations 2003, reg 73. The words in reg 205 were “emphatic and mandatory” — returns had to be filed electronically.

Although HMRC had no record of receiving the paper return, if it had, it would have made no difference to the outcome of the appeal.

The taxpayer's appeal was dismissed.

**Comments –** Again this is a case which is self-explanatory and consequently the appeal was dismissed.

*M Haynes Ltd v HMRC TC3418*

## Defective notice

In 2009, HMRC enquired into the taxpayer's company accounts because they included a £700,000 contribution to a remuneration trust. In July 2012, after several years of correspondence, the department issued an information notice under FA 2008, Sch 36 requiring the company to provide two pieces of information and two documents. The company appealed against the notice. It said it had complied as far as it could, but that the notice was defective because it asked for subjective opinion “which was not lawfully required to be provided”.

*Decision:*

The First-tier Tribunal said information notices should “be expressed in clear terms” so that both parties know whether it has been complied with. That was why HMRC guidance states that notices should request facts, not opinion. In this instance, the notice contained built-in assumptions that “made it impossible” for the company and HMRC to know whether the requests had been met because the company did not agree with the accuracy of those assumptions.

The judge decided the notice should be set aside. She warned the company that this did not preclude HMRC from serving another, better-worded, notice.

The taxpayer's appeal was allowed.

**Comments –** Elements of this decision bear repeating: information notices should “be expressed in clear terms” so that both parties know whether it has been complied with. HMRC guidance states that notices should request facts, not opinion. This was not the case and so the taxpayer’s appeal was allowed. The judge’s last point of course does not prevent HMRC getting it right next time around.

*RD Utilities Ltd (TC3440)*

## Were interest payments UK sourced? Reliance on unpublished decision

The FTT found that payments made by a UK company to offshore trusts and companies arose in the UK.

Ardmore was appealing against HMRC's decision to tax interest it had paid to offshore trusts and companies on the basis that the interest arose in the UK (ITA 2007 s 957). Ardmore was a construction company owned by two brothers in equal shares. The company held shares in BVI companies which were controlled by family trusts established by the two brothers. During the tax year 2007/08 the interest paid by Ardmore was more than £5m, which was funded by its UK trading activities. HMRC contended that Ardmore should have withheld tax on the interest payments. A decision of the FTT in 2004 had turned on a similar point; Perrin v HMRC [2014] UKFTT 223. However, the judge had referred to Poldi, which was an unpublished decision. The appellant contended that the reliance on Poldi had resulted in a 'serious procedural impropriety' and that therefore the Perrin case should not be referred to.

*Decision:*

The FTT, referring to Fothergill v Monarch Airlines [1981] AC 251, considered that it would be unfair to the taxpayer to allow HMRC to refer to unpublished decisions to which the taxpayer did not have access. The FTT therefore set out to consider the appeal 'afresh'.

Having extensively reviewed the case law and, in particular, National Bank of Greece [1970] 46 TC 472, the FTT noted that the courts considered and weighed a variety of factors, including the residence of the debtor, the place of enforcement of the debt against the debtor, the residence of any guarantor, the location of any security, the situs of the debt, the proper law of the contract, and the place of payment of the interest.

Applying a multi-factorial approach, the FTT noted that Ardmore was resident in the UK so that the situs of the debt was in the UK. The UK would also be the place of enforcement of the debt. The FTT therefore concluded that the interest arose in the UK.

**Comments -** According to the FTT, whether a tax tribunal could rely on an unpublished decision had never been considered. This decision is therefore likely to become the reference in this respect. As for the substantive point, the FTT seems to have given great weight to the fact that Ardmore was UK tax resident when deciding that interest paid by it had a UK source.

*Ardmore v HMRC TC3580*

## HMRC's obligation to disclose to third parties

The High Court quashed HMRC's decision not to release information about a UK company suspected to have supplied malicious computer software to repressive regimes.

Privacy International was a nongovernmental organisation (NGO) dedicated to investigation in relation to privacy at the international level with a particular focus on the unlawful use of surveillance. It had applied for judicial review on its own behalf and also sought to represent the interests of two political activists who, allegedly, were the victims of unlawful and criminal surveillance (using malicious computer software) by the security forces of Bahrain and Ethiopia.

The NGO claimed that the equipment used in Bahrain and in Ethiopia by security forces was supplied illegally to those states by Gamma International in breach of export regulations applicable to that company in the UK. The NGO had complained about the conduct of Gamma International to HMRC, which replied that it had no power to provide information about its investigations.

*Decision:*

The court first observed that Gamma International was not a party to the proceedings so it could not make any findings on the actual merits of the complaint. However, the court did recognise that HMRC had the statutory power to enforce the relevant export controls to the types of surveillance products alleged to have been used in Bahrain and Ethiopia. HMRC contended that the Freedom of Information Act 2000 was disapplied in relation to categories of information (FOIA 2000 s 44(1)), whose disclosure is prohibited under CRCA 2005 s 18. The key was therefore the interpretation of CRCA 2005 s 18 and HMRC's margin of discretion to disclose. Referring to the Supreme Court's decision in Kennedy [2014] UKSC 20, the court noted that the right balance had to be struck between disclosure — as 'information underpins democracy' — and non-disclosure — when information is 'genuinely private and confidential'. The court concluded that HMRC's decision had to be taken again. The letters sent by HMRC contained inaccuracies, as they suggested that any request for information should be dismissed, and HMRC had failed to obtain evidence from the relevant operational unit and to consider the merits of the complaint itself. The court then turned to the factors HMRC should consider when exercising its discretion to disclose. It first noted that NGOs, like the press, held the government to account and referred to Ingenious Media [2013] EWHC 3258. Here, the court recognised that 'dissemination of information to stimulate public debate was “strongly in the public interest in a well-functioning democracy”'. The court added that HMRC could have made a disclosure under conditions of confidentiality or chosen to make a limited disclosure.

As for the victims, the court referred to the Framework Decision, which was adopted to implement the conclusions of the European Council meeting in Tampere in October 1999. This stipulated that 'minimum standards should be drawn up on the protection of the victims of crimes, in particular on crime victims' access to justice'. Article 1 of the Framework Decision defines 'victim' as 'a person ... who has suffered harm ... directly caused by acts or omissions that are in violation of the criminal law of a member state'. The court did not decide whether the two political activists were 'victims' for this purpose but stressed that direct causality was essential.

The court added that HMRC should also decide whether witnesses and Gamma International should be informed. As far as the company was concerned, issues such as the risk of forewarning a suspect should be considered, but they did not justify a blanket prohibition on disclosure. As for the possible damage to the company's reputation, it had to be balanced with the public interests in transparency and disclosure. In this respect, the court noted that many regulators routinely announce the existence of investigations into companies. In addition, the court accepted that maintaining confidence in the system was a relevant consideration but insisted that it had to be reviewed case by case. Finally, the court examined the right of the activists to communication of the decision taken whether to prosecute.

This right would emanate from common law, from the positions of the activists as 'qua victims' under the relevant EU legislation and pursuant to ECHR art 10. Referring to Corner House [2008] UKHL 60, the court considered that there were cogent reasons in favour of decisions not to prosecute being notified to affected persons together with reasons and this would apply to the activists.

**Comments -** This decision is only the second one (after Ingenious Media) in which HMRC's power to disclose information to third parties was examined. As pointed out by the High Court, the case law is still too succinct for HMRC to be able to draw the applicable guidance. This case and Ingenious Media are therefore highly relevant to anyone wishing to challenge a decision of HMRC not to disclose (or to disclose) information.

*R (on the application of Privacy International) v HMRC (CO/4089/2013)*

## Abolition of Percentage Threshold Scheme (PTS)

The Low Incomes Tax Reform Group has pointed out that the abolition of the PTS (a compensation scheme for small employers faced with high levels of sick ness absence) from 6 April 2014 will have a significant adverse impact on 'care and support employers', possibly costing vulnerable employers up to £2,500 a year. The change will affect those who take on a personal assistant employed to help them with their care needs – a group already denied access to the £2,000 NIC employment allowance.

The PTS provided a measure of compensation for employers faced with high levels of sickness absence. Unless an employer qualified under PTS they would not be entitled to recover any of the Statutory Sick Pay (SSP) paid to their employees. An employer was entitled to recover some of the SSP actually paid to their employees if the total amount of SSP paid in a tax month was greater than a set percentage of their gross Class 1 NICs (employers' and employees') liability for that tax month. The amount the employer could recover was the SSP they had paid over and above the set percentage threshold of their NICs liability.

From 6 April 2014, employers are no longer able to claim reimbursement for SSP, following the abolition of the PTS.

Most employees are entitled to receive SSP from their employers for up to 28 weeks of sickness absence. SSP is payable on a daily basis at a flat weekly rate of £86.70 (in 2013/14), usually from the fourth day of sickness onwards. Before 6 April 2014, employers claimed reimbursement of SSP through the PTS to the extent it exceeded 13% of their combined employer/employee NIC in that tax month.

*Example*

The only employee of a small business usually works 7 hours a day Monday to Friday at £6.31 an hour. The employee's gross weekly pay is £220.85, meaning the employee NIC was £8.62 and employer NIC was £10.05 totalling £18.67 NIC per week. That employee is off sick for one week in January and they get paid SSP of £34.68 by the employer (weekly amount of £86.70 prorated with the first three days unpaid). If the combined NIC in January 2014 was £56.01 (£18.67 x the three weeks the employee was working in January) then the employer was able to recover £27.39 of the SSP from the government (the amount by which the SSP paid exceeded 13% of the NICs in that month).

*Care and support employers*
Individuals who take on a personal assistant (carer) to help them live independently become an 'employer' and therefore are responsible for paying SSP, as any other employer would be, when their carer is off work through illness. The money to pay for the care will either come in the form of state support or own funds.

Assume the employee in the example above was a carer working for a care and support employer. If this employee was off sick not just for one week, but for a whole month, or even the full 28 weeks, the SSP payable would be more like £2,500 – all of which would have been reclaimable under the PTS if that was the only employee and there was no other employee or employer NIC going through the payroll while the carer was off. This would very likely be the case where an agency care worker was taken on as an interim replacement, as the agency would process that worker's pay and deductions.

The Government commissioned an independent health review in 2011 that concluded the PTS was not encouraging employers to manage sickness absence in the workplace and instead was acting as a perverse incentive to allow longer periods of sickness. They also felt that the PTS scheme was a burden on employers to administer.

The Government has said that the money saved from the PTS abolition will be used to fund a new health and work assessment advisory service that will help employers reduce sickness absence.

## Get the engagement letter right **(Lecture P838 – 6.13 minutes)**

*The case*

When Mr Mehjoo, a non UK domiciled individual, sold his company he used the capital redemption planning scheme to shelter a gain of £8.5 million but the scheme subsequently failed. Had he used the bearer warrant scheme, he would have succeeded.

He sued his advisers and in the High Court the accountants were held to be negligent for not suggesting a workable scheme. They were liable for the £850,000 tax saving that would have been achieved less the cost set-up costs.

*Establishing a negligence claim*

To establish such a claim the claimants must prove all of the following:

1. Person who has allegedly been negligent owes a duty of care to the claimant
2. Claimant must demonstrate that there has been a breach of that duty of care
3. Claimant must prove they have suffered a loss as a result of the breach of the duty of care

*Appeal to the Court of Appeal*

On appeal the case was overturned.

The accountants were acting as 'general accountants' and the retainer letter had not imposed an obligation on the accountants to advise Mr Mehjoo as to how he might minimise his tax liabilities unless specifically requested to do so. No such request was made and it was not reasonable to expect generalist accountants to be aware of the Bearer Warrant Scheme and so there was no duty of care.

*Lessons learned*

It is clear that as practitioners we must:

- Make sure that engagement letters are clear over which services are and are not provided.
- Not offer advice outside our areas of competence
- Ensure that all engagement letters emphasise the compliance nature of the engagement and that whilst the firm can undertake tax planning work that would be subject to specific request
- Prepare separate engagement terms when requested to undertake tax planning
- Seek advice from specialist firms where we are requested to provide services outside of the firms expertise

## HMRC's flawed use of business models (Lecture P839 – 8.39 minutes)

There have been a number of cases over the years which cast major doubts over HMRC's attempts to use a business model to show that business profits must have been understated.

*Glenn Whittle v HMRC TC03393*

The taxpayer was a taxi driver and HMRC used a standard model of income and expenditure to suggest that his declared income was less than his expenditure with the conclusion that there was undeclared income.

Mr and Mrs Whittle's domestic circumstances did not fit the standard model (e.g. the mortgage was in joint names but the repayments were effectively from Mrs W's income). The FTT decided that their joint income was commensurate with their joint expenditure based on the evidence supplied, and therefore there had been no under-declaration of income.

Using a standard model of expected income and expenditure to determine undeclared income for a year in isolation could produce an incorrect result. Part of the income receipts declared in fact related to a "drawdown" pension where, by definition, variable pension amounts can be drawn (within limits) in any tax year.

Clearly, said the FTT, if a taxpayer had drawn down a significant amount in one year and nothing in the next, they lived off the income in the first year. If HMRC investigated the later year it might seem there was low income.

As far as the impact of Mrs W's income was concerned, HMRC did not raise an enquiry into her tax affairs despite their ability to do so. Therefore, said the FTT, she was entitled to privacy and did not have to disclose information. She nevertheless did provide information to assist with the enquiry into her husband's tax affairs but she was not obliged to in the absence of an enquiry into her own position.

The FTT pointed out that in contrast to Mrs W, HMRC repeatedly refused to give information about other taxpayers when requested to do so by appellant taxpayers on the same grounds.

Another aspect in this case was whether adequate business records were kept. Section 12B TMA 1970 concerns the requirement for records to be "requisite for the purpose of enabling the taxpayer to make and deliver a correct and complete return". HMRC had been asked to provide details of any specific requirements in respect of Mr W's activities, but none were supplied. The FTT decided that here the records supplied were sufficient and met the requirements of Section 12B. Mr W had maintained an income and expenditure record book based on slips of paper but they had been destroyed. The fact they were destroyed was not a reason to cite inadequate record keeping as they were not the primary records and were "of no more than evidential value than a weekly summary of the same".

*Farthings Steak House v McDonald SpC91*

This case has always illustrated that where HMRC proposes an adjustment to business profits there are many different ways of arriving at what they consider to be the correct figure. The use of a business model was severely criticised in this case although clearly it can have some merit. If HMRC relies on that entirely, you should be able to resist by reference to the particular circumstances of the business which may well fall outside any supposed model used by HMRC.

Capital statements are a somewhat old-fashioned way of establishing the level of undeclared income, but may well be the best route for you to take in disputing any HMRC contention. As it is a time-consuming approach you should discuss the possibility with the client and perhaps use it as a threat when talking to HMRC.

The level and range of private expenditure needs to be established if going down the capital statement route. In ***Para EM3670*** of the ***Enquiry Manual***, HMRC talks of categorising expenditure between essentials and optionals, or attempting to categorise expenditure and deal with each item exhaustively. It then gives a non-exhaustive list of possible items and this should be used where appropriate. They also refer to a detailed aide-memoire that is aimed at helping HMRC to cover most foreseeable aspects of private expenditure. The programme contains a calculator to convert regular payments into annual amounts, and HMRC are advised to use the aide-memoire with the taxpayer's individual circumstances in mind. The template should not, they say, be given out like a questionnaire for the taxpayer to fill in.
*Mr Ho v HMRC TC00669*

HMRC were also criticised by the Tribunal in this case. HMRC argued that a taxi driver operating out of Heathrow Airport could identify potential fares and thus not have to return to Heathrow with an empty cab. The Tribunal found Mr Ho to be a credible witness who preferred a lower income and less hectic work life. They rejected HMRC's conclusions from a cash-flow exercise which they held to be flawed.

*Contributed by Gerry Hart*

## HMRC'S attack on incorporation of medics (Lecture P840 – 9.06 minutes)

This started by an announcement that a cross-directorate project had been created to examine, and if appropriate challenge, business goodwill valuations used in incorporations involving Medical Professionals.

HMRC started the ball rolling by stating that their view is:

- a company cannot carry on a profession, and
- if it employs professionals to exercise their profession as employees of the company, it has not succeeded to the practice previously carried on by the professionals in their own right

It follows, they said, that a number of key concerns arise in connection with incorporations involving medical professionals:

- whether any goodwill involved is actually personal to the individuals involved by virtue of their professional skills and reputation and therefore not capable of being transferred?
- whether a business that is capable of being sold as a going concern in the open market is involved, and if so, whether and to what extent any goodwill of value resides in that business?

That opening and rather vague gambit was followed up by a host of questions, although in the apparent extension of the project to dentists they have not yet asked questions and say simply that the project team are deliberating on what their future actions might be. To recap, the main questions were:

- What were the main reasons for the incorporation of the business?
- Full details of any changes to the business in the four years to the date of valuation
- Full details of any comparable sales of similar businesses between unconnected parties upon which the goodwill valuation may rely – these should be acquisitions by corporate unconnected bodies or partnership businesses
- Details of the registration of the business with the Care Quality Commission (CQC) and copies of any reports/inspections made by the CQC
- If NHS work is part of the fee income we will require a copy of the NHS/PCT contract and its assignment

Where the incorporation of a medic is involved HMRC seem to have taken a different approach altogether, building on the last two questions above by now asking for supplementary documents etc. These include the following where their line of attack revolves around what evidence exists that the practice was indeed transferred:

- the Practising Privilege agreement with the hospitals where the medic practised prior to the transfer
- any new Practising Privilege agreement with the company, or amendment to the original

- any other agreement if income is received from insurers and/or private hospitals, governing the relationship between them and the medic and then with the company
- letters to referring doctors, hospitals etc informing them of the cessation of the sole practice and the commencement of employment and offering of services through the company
- in relation to any referrals made prior to the transfer date, any correspondence notifying the referring doctor of the change
- documents supporting the contention that a singleton medical practice has been sold to an unconnected third party, with the purchase of goodwill or any further information in that connection – if nothing is found they ask you to say so
- documentary evidence of the medic's future intentions as regards the practice, which may include any steps taken to bring in another doctor into the practice; any steps taken to ready the practice for his eventual retirement; or any medical work undertaken by another person for the company

*Contributed by Gerry Hart*

# Business Taxation

## Another increase in the annual investment allowance (Lecture B836 – 24.07 minutes)

Since April 2008, most businesses – regardless of size – have been eligible to claim the 100% AIA on capital expenditure on plant or machinery, but only up to a specified annual amount (which has been the subject of frequent change).

With effect from 1 (or 6) April 2012, the annual limit was reduced from £100,000 to £25,000 for qualifying expenditure incurred on or after those dates.

FA 2013 temporarily increased the maximum AIA amount from £25,000 to £250,000 for the two-year period from 1 January 2013 to 31 December 2014 (inclusive).

The Chancellor has recently announced his intention to extend the period of this temporary increase by an extra 12 months, ie. until 31 December 2015, and furthermore to double the AIA limit to £500,000 from 1 April 2014 (for companies) and 6 April 2014 (for unincorporated businesses). The detailed rules (including the important transitional measures) are set out in Cl 10 and Sch 2 FB 2014.

For expenditure incurred on or after 1 January 2016, the maximum AIA entitlement returns to its previous limit of £25,000.

Having had to absorb the FA 2013 capital allowances changes, practitioners will not be surprised to learn that the latest set of transitional rules are also somewhat complicated. Initially, two separate scenarios need to be considered:

1. where the chargeable period which straddles 1 (or 6) April 2014 begins before 1 January 2013 – this can only happen if an unincorporated business has changed its accounting date; and

2. where the chargeable period which straddles 1 (or 6) April 2014 begins on or after 1 January 2013.

The maximum allowance under S51A CAA 2001 for any such straddling period is comprised of the aggregate of the sums which would be found on a pro rata basis:

- for that part of the straddling period which falls before 1 January 2013 (if any);

- for that part of the straddling period which falls on or after 1 January 2013 but before 1 (or 6) April 2014; and

- for that part of the straddling period which falls on or after 1 (or 6) April 2014,

treating each part as though it were a separate chargeable period.

*Illustration*

David & Co is an established partnership business which has recently changed its accounting date. For many years, the partnership has traded to 30 November, but, in 2013, a decision was taken to move the year end to 31 May, with the result that there is an 18-month period running from 1 December 2012 through until 31 May 2014.

The firm's maximum AIA entitlement for that 18-month period is based on:

- the allowable proportion for the first period, ie. from 1 December 2012 to 31 December 2012 (1/12 x £25,000 = £2,083);
- the allowable proportion for the second period, ie. from 1 January 2013 to 5 April 2014 (15/12 x £250,000 = £312,500); and
- the allowable proportion for the third period, ie. from 6 April 2014 to 31 May 2014 (2/12 x £500,000 = £83,333).

This comes to £2,083 + £312,500 + £83,333 = £397,916.

However, where any part of the straddling period falls before 1 January 2013, the maximum allowance for expenditure actually incurred in this part is the amount which would have been the limit had the two temporary AIA increases *not* been made. So, for expenditure incurred in the first period in Illustration 6, the position would be:

| | £ |
|---|---:|
| 1/12 x 25,000 | 2,083 |
| 15/12 x 25,000 | 31,250 |
| 2/12 x 25,000 | 4,167 |
| | £37,500 |

In other words, if David & Co had incurred qualifying capital expenditure of, say, £33,000 on 15 December 2012, the partnership would be entitled to a full AIA.

In relation to expenditure actually incurred before 6 April 2014, the maximum allowance for the whole of the straddling period is taken to be the amount which would have been the business' entitlement on the assumption that there had been no increase in the AIA limit from £250,000 to £500,000. For David & Co, the maximum allowance is:

| | £ |
|---|---:|
| 1/12 x 25,000 | 2,083 |
| 15/12 x 250,000 | 312,500 |
| 2/12 x 250,000 | 41,667 |
| | £356,250 |

Given that the firm had already spent £33,000 on plant or machinery in December 2012, this means that David & Co could claim an AIA on capital expenditure incurred between 1 January 2013 and 5 April 2014 (inclusive) of £356,250 – £33,000 = £323,250. If the firm had incurred qualifying expenditure of, say, £270,000 during this 15-month period, it would all be eligible for 100% relief.

The partnership's overall limit for the 18 months to 31 May 2014 is £397,916. Since it has already attracted relief on £33,000 + £270,000 = £303,000, a balance of £94,916 (£397,916 – £303,000) is still available for the last two months of the straddling period.

The legislation also provides a set of rules where the straddling period begins on or after 1 January 2013. In this case, the maximum AIA entitlement for, say, a company is found by time-apportioning the allowance from the start of the chargeable period up to 31 March 2014 and from 1 April 2014 up to the end of the chargeable period. Thus, for a company with a 31 December accounting date, the position is:

| | £ |
|---|---|
| 3/12 x 250,000 | 62,500 |
| 9/12 x 500,000 | 375,000 |
| | £437,500 |

The company's maximum AIA claim for the year is £437,500. However, insofar as any expenditure is incurred in that part of the chargeable period falling before 1 April 2014, the limit has to be calculated as if the increase to £500,000 had not been made. In other words, expenditure of up to £250,000 can be covered for this three-month period. On the assumption that exactly this amount has been spent, the company would have to incur qualifying expenditure of a further £187,500 (£437,500 – £250,000) on or after 1 April 2014 if it wanted to benefit from the maximum AIA available to it for this straddling period.

With regard to any chargeable period which straddles 1 January 2016, the new provisions mirror the legislation found in Para 4 Sch 1 FA 2013 when the reduction to £25,000 was originally expected to be made. A time-apportioned calculation is used to establish the maximum AIA entitlement for the company or unincorporated business, but, for expenditure incurred in any part of the chargeable period falling on or after 1 January 2016, the maximum allowance is restricted to the relevant proportion of £25,000. This will be a serious potential pitfall. Companies and unincorporated businesses are being encouraged to incur their expenditure on plant or machinery *before* the end of 2015.

*Contributed by Robert Jamieson*

## Partnerships – a revised regime **(Lectures B837/ B838 – 32.28/ 22.05 minutes)**

On 20 May 2013, HMRC issued a consultation document on partnerships with a view to stemming the tax loss which, in their view, they were experiencing from the exploitation of the partnership rules. The closing date for comments on this paper was 9 August 2013 and the Finance Bill now contains the detailed legislation (Cl 68 and Sch 13 FB 2014).

These notes cover two aspects of the amendments introduced by the revised partnership regime which, in the main, take effect for 2014/15 onwards.

They are described by HMRC as:

1. disguised employment in LLPs; and

2. the tax-motivated allocation of business profits and losses in all types of partnership.

*Salaried member legislation*

This is the title which HMRC have chosen for the provisions dealing with the problem of disguised employment and LLPs. However, it will be sensible, first of all, to highlight the key issues in the original consultation.

The rationale for the introduction of the concept of LLPs was to provide a corporate vehicle which would be taxed in the same way as an unincorporated partnership. Unfortunately, from HMRC's perspective, the framers of the Limited Liability Partnerships Act 2000 went too far in enshrining this principle. They introduced a provision which ensured that individuals who are members of an LLP are always taxed as if they were partners in a general partnership, despite the fact that they may be engaged on 'salaried partner' terms, ie. on terms which are closer to those of an employment. This produced a perceived unfairness in that a salaried member of an LLP has hitherto enjoyed a more favourable tax treatment than an individual who is an employee of a company or even a salaried partner within a general partnership. In addition, the LLP is not liable for employer's NICs on the member's profit share, unlike the position with an employee.

In HMRC's eyes, LLPs have increasingly been used to disguise employment and so avoid employment taxes.

Accordingly, their original proposals were twofold:

1. to remove the presumption that all individual members of an LLP are to be treated as self-employed for tax purposes; and

2. to set out the factors to be taken into account in deciding whether an individual member of an LLP should in reality be treated as an employee – this involved applying the 'employment v self-employment' tests in the Employment Status Manual and examining the level of the individual's economic risk in connection with his firm.

In the event, HMRC's plans have changed. They have decided not to use the tests in the Employment Status Manual as it was felt, on reflection, that they would not be appropriate for a large number of LLPs. The problem was that many LLP members would have failed these tests (and so would have been categorised as employees for tax purposes), even where they might hold a genuine equity stake in their business.

HMRC have instead introduced a three-step test in order to determine whether a member has a genuine equity stake in his firm. The details are set out in new Ss863A – 863G ITTOIA 2005 (as inserted by Para 1 Sch 13 FB 2014).

Under these rules, a member of an LLP will be treated as an employee for tax and NIC purposes if *all* of the following conditions are satisfied:

*Condition A*

This considers the manner in which the individual is rewarded for his performance of services to the LLP. A salaried member will have an earnings package which is similar to that which an employee would have. This means that he will be wholly or substantially remunerated through a fixed salary and/or a variable bonus based on his performance rather than on the overall profitability of the firm – this arrangement is referred to as a 'disguised salary'. In this context, the word 'substantially' was not originally defined in the legislation. However, in practice, HMRC confirmed that they would consider that Condition A has been met if 80% or more of the amounts payable to the individual for his services to the LLP are expected to be in the form of a disguised salary. This has now been made statutory. It is likely that many 'fixed equity' members of an LLP will come within Condition A. Indeed, it is possible that some full equity partners may also be caught if, for example, the firm shares out its profits by reference to a combination of salary tranche with an element of participation in the remaining profit pool, but this latter component is expected to be 20% or less of the overall package.

*Condition B*

This deals with the situation where the individual does not have a significant say in the running of the business as a whole. The main point to make is that a member who has substantial influence over *part* of the business (eg. because he runs a division) will satisfy Condition B. In large LLPs, it is likely that only the members of the management board will not pass this test. Conversely, in the case of a small LLP with four or five members, even a junior partner may be able to demonstrate significant influence.

*Condition C*

This looks at the capital contribution made to the LLP by the individual. A partner in a traditional partnership risks losing money if the business fails. To reflect this, an individual may be classified as a salaried member if the amount of money which he has invested in the LLP is less than 25% of the disguised salary expected to be payable to him for that tax year. How does one determine the amount of an individual's capital contribution in this context? It will comprise capital or borrowings which are committed to the firm for the period of the individual's membership of the LLP. Short-term loans, undrawn profits and sums held in a tax reserve account will not be included.

In relation to Condition A, there are three questions which need to be answered:

1. Are there arrangements in place under which the member performs services for the LLP?
2. What does the member reasonably expect to receive by way of payment from the LLP?
3. How much of this payment represents a disguised salary?

It is a prerequisite that the member must be performing services for the LLP. Thus a member who has been placed on 'gardening leave' prior to his departure to a rival firm would not fulfil this condition, given that any payment which he receives during this period will not be for 'services'.

As far as 2. is concerned, the test is framed in terms of the profit share which the member might reasonably be expected to receive. Where there are several different possibilities, HMRC's 'Revised Technical Note And Guidance' published on 27 March 2014 explains that the most realistic outcome is the one which should be used.

*Illustration*

Peter has the following interests in an LLP:

- he contributed capital of £20,000 when he joined the firm in accordance with the LLP Agreement;
- at the same time, he made a long-term loan of £50,000 to the firm – interest is paid on this loan, but otherwise the amount is held on terms which are comparable to Peter's capital, ie. the loan is only repaid when Peter resigns or when the LLP is wound up;
- he subsequently made a further loan of £30,000 for a two-year term;
- he has undrawn profits of £45,000 – these can be taken out at any time; and
- there is £28,000 in a tax reserve account which will be used to pay tax on Peter's share of profits.

The last three items are not part of Peter's capital contribution. Because Peter cannot withdraw either the sum described as 'capital' or the sum described as a 'long-term loan', Peter is deemed to have a capital contribution of £20,000 + £50,000 = £70,000.

*Summary*

To summarise, if an individual is a member of an LLP and:

- the reward for his performance of services is fixed or variable (but without reference to the firm's profits);
- he has no significant say in the running of the business as a whole; and
- he has no significant monetary investment in the firm,

that individual will be a salaried member. He will be treated as an employee and will therefore be subject to PAYE, Class 1 NICs and tax on benefits in kind. Note that, in order to be caught, all three conditions must be satisfied. If any one of them is not, the individual will continue to be treated as self-employed.

*At what stage are the three conditions applied?*

With reference to Conditions A and B, the answer is 6 April 2014 in the case of individuals who are already members of the LLP. For someone who becomes a member subsequently, the test needs to be applied at the date on which they become a member. Once the tests have been applied, they do not have to be reapplied until there is a change of circumstances which could give a different result.

Condition C does not work in quite the same way. Initially, it was similar to the other two conditions in the sense that the question of whether Condition C is met needed to be determined on 6 April 2014 or, if later, at the time when the individual becomes a member of the LLP. However, following a rethink, it has been decided that, for existing members, the capital contribution condition must be met by 5 July 2014. In the case of new members, the critical time limit is the end of a period of two months beginning with the date on which the individual became a member of the LLP. Thereafter, the condition must be tested at the start of *every* tax year.

The anti-avoidance legislation found in S863G ITTOIA 2005 is intended to deter the use of artificial arrangements in order to position partners outside the scope of the salaried member rules. As a result, arrangements are ignored where there are put in place with a main purpose of ensuring that someone is not a salaried member.

For example, consider Simon who is a junior partner in an LLP. He only has a nominal capital investment and he satisfies Conditions A and B. He therefore receives a non-recourse loan in order to raise his capital contribution to a level so that Condition C is not met. The main purpose of this loan is to enable Simon to avoid being treated as a salaried member. The additional capital is disregarded, Condition C is satisfied and so Simon becomes a salaried member.

*In the light of all this, what needs to be done?*

If an LLP includes members who meet Conditions A, B and C, the new regime will be expensive, involving, as it does, the recategorisation of partners as employees. There is also the potential for uncertainty where members on the margin can slip in and out of employment status. This could happen, without any other changes taking place, if projected profits fluctuate so that an individual's disguised salary in some years represents 80% or more of his projected remuneration but in other years is less than 80% of this figure. As one commentator has pointed out:

> 'This could cause the application of the opening year and closing year rules and all the complication that goes with this. Applying these rules could be enormously complex where the firm has other than a 31 March year end as the deemed salary (where it is ruled that there is a disguised employment) will arise in a different tax year to the allocation of profit (where it is ruled that the member properly qualifies to be treated as a partner).'

*Partnerships with mixed membership*

One attraction of partnerships and LLPs is that they are seen as offering more freedom for tax planning than other business structures such as companies. It is well known that, in recent years, many individual partners have used the flexibility afforded by partnerships and LLPs to obtain tax advantages, typically with the introduction of a corporate partner. Partnerships involving a combination of individuals and companies are referred to as mixed partnerships.

In the original consultation document, HMRC wanted to say that profits allocated to a corporate partner would be treated for income tax purposes as arising to an individual partner where:

- the partnership or LLP comprised both members who were within the charge to income tax and members who were not;
- there was an economic connection between the members so that individuals were able to benefit, directly or indirectly, from partnership profits allocated to non-individual members; and
- it was reasonable to assume that the main purpose, or one of the main purposes, of the partnership profit sharing arrangements was to secure an income tax advantage.

Many of the respondents to this paper argued that the HMRC proposals represented an overreaction and that it would be better to develop more targeted rules to deal with any mischief which HMRC had identified. Several focused on the benefits of retaining profits in a mixed partnership to fund working capital (ie. where profits are taxed at more modest corporation tax rates rather than higher personal tax ones) – preventing this would confer incorporated businesses an important advantage over partnerships. In the event, however, HMRC have not altered their overall approach. They want to make a structural change to the rules for partnership taxation rather than try to combat specific instances of tax avoidance. That said, HMRC have modified their stance. The 'main purpose' test has been set aside and replaced with one which is rather more objective. The aim of the latest test is to see whether it is reasonable to assume that the *effect* – note that this is not the same as 'purpose' – of the mixed membership profit sharing arrangements is to reduce the aggregate tax payable. If it is, the new provisions will bite.

Individual partners can reduce their tax liability by diverting all or part of what would otherwise be their normal profit share to a corporate entity which will nearly always be more lightly taxed than the individual. The legislation published in the Finance Bill – this is found in new Ss850C – 850E ITTOIA 2005 (as inserted by Para 7(3) Sch 13 FB 2014) – allows such profit sharing arrangements to be overridden so that individual members are now to be taxed on the profits which have been diverted in such circumstances. However, these rules do not apply to mixed membership partnerships or LLPs where the individual and non-individual partners are genuinely acting at arm's length.

On the other hand, where there are losses, the loss allocation arrangements will normally ensure that all or most of the partnership losses are attributed to the individual partners rather than to any company so that they can enjoy a more generous level of loss relief. This situation is addressed by the insertion of new S116A ITA 2007 which states that loss relief will not be available if the relief arises as a result of what are called 'relevant tax avoidance arrangements' (see S116A(3) ITA 2007).

Looking at the new rules for mixed partnership profits, the Finance Bill will prevent profit allocations to a corporate member from taking effect for tax purposes where these exceed the notional value of any services or capital which the company provides to the partnership. In addition, there is a requirement that the individual to whom the company profits may be transferred must have 'power to enjoy' the corporate profit share – this is defined in S850C(18) – (20) ITTOIA 2005. 'Notional value' is measured prescriptively so that it cannot include more than a small mark-up on the cost of providing any services or a reasonable return on any capital or loan put into the partnership.

*Illustration*

The membership of an LLP consists of three individuals, Alan, Brian and Charles, who decided that they need to retain funds in their partnership for working capital. In order to avoid the retained profits being taxed at higher income tax rates, they introduced a corporate member (ABC Ltd) which is owned by the three of them equally.

The revised profit sharing ratio is:

| | |
|---|---|
| Alan, Brian and Charles | 30% |
| ABC Ltd | 70% |

ABC Ltd does not provide any services to the LLP but has made a £500,000 non-interest bearing capital contribution to the firm.

If the LLP's profits are £400,000 for the year, £280,000 will be allocated to ABC Ltd. However, applying an interest rate of, say, 4% to the company's loan, this would mean that ABC Ltd was entitled to a notional profit of 4% x £500,000 = £20,000. The balance of £260,000 would therefore have to be reallocated to Alan, Brian and Charles.

In essence, the mixed partnership legislation only applies to periods of account beginning on or after 6 April 2014. However, where a period of account straddles 6 April 2014, it is necessary to consider the time from 6 April 2014 to the end of the period of account. Does the mixed partnership legislation apply to this part? If the answer is no, the new rules start with the following period of account. If the answer is yes, the profits have to be calculated as though there were two notional periods of account:

(i) one ended on 5 April 2014; and

(ii) the other beginning on 6 April 2014.

The new rules are then applied to the second period. The commencement dates for excess loss allocations are similar.

When looking at suggestions for counteraction where a mixed partnership is caught by the new regime, the following ideas should be considered:

- outright incorporation;
- elimination of the corporate member and acceptance of the income tax result;
- establishment of a company owned by the partnership (ie. a 'subsidiary'); and
- retention of the existing structure but with a corporate member's profit share which can be justified.

*Contributed by Robert Jamieson*

## Icebreaker scheme fails

The scheme implemented by the Icebreaker partnerships failed. The partnerships were set up as music industry investment schemes. All the appellants were members of the partnerships, which had implemented arrangements giving rise to an accounting loss in each of the partnerships' first accounting period. The loss was derived from the acquisition of intellectual property rights for a modest sum and the payment of a substantial exploitation fee to an exploitation company. The injection of capital by each member was partly financed by borrowings which were to be serviced by a guaranteed return on investment for the members. The appellants claimed that they were entitled to sideways loss relief against their income and capital gains tax liabilities (ICTA 1988 ss 380 and 381, TCGA 1992 s 261B and ITA 2007 ss 64, 71 and 72).

*Decision:*

The FTT considered that the payments to the exploitation company, which represented the purchase price of a guaranteed income stream, were of a capital nature. The profit and loss accounts of the partnerships which included those payments were therefore not GAAP compliant and must be redrawn. The FTT concluded that the losses made by the partnerships must be lower than claimed by the appellants but higher than suggested by HMRC. Therefore, the appeals against the closure notices must be partially allowed (to a very modest extent). HMRC also contended that the arrangements were structured so that the members were guaranteed at the end of the sequence to be put back in the position from which they started. According to HMRC, the arrangements must therefore be recharacterised, applying the Ramsay doctrine. The FTT disagreed, on the basis that the transactions were ineffective in any event. Once the partnerships' accounts were redrawn to comply with GAAP, only those payments which were of a revenue nature and made in respect of expenses incurred for the purpose of the trade in the relevant year would be brought into the profit and loss account for that year. The FTT did, however, accept that Ramsay could, in theory, apply to the transactions. It concluded that, as in Tower MCashback [2011] AC 457, the borrowings served no useful purpose but the inflation of the supposed loss. The artificial steps could therefore be disregarded.

The FTT also found that the partnerships did not show any sign of becoming profitable, to the extent that it might be realistically expected that the capital injected in them might be recoverable within a reasonable timescale. Therefore, the trades were not carried out on a commercial basis with a view to profit. Consequently, sideways loss relief would not have been available in any event (ICTA 1988 s 384). The members were not active partners and their activities were not carried out for the purpose of the trade. For instance, they were supplied with music recordings only for the purpose of satisfying the statutory requirements. They therefore failed the test of ITA 2007 s 103B(1). The arrangements were however not a sham and the liability to repay the loans remained with the members. The arrangements therefore did not fall foul of the conditions of the Partnerships (Restrictions on Contributions to a Trade) Regulations, SI 2005/2017.

**Comments -** The total amount of tax at stake was in excess of £134.5m and so the losses for investors may be in excess of £70m. The decision is also likely to affect other similar partnership arrangements in which the partners are not active.

*Acornwood and others v HMRC TC3545*

## A car valeting structure is not 'plant'

The FTT held that a car valeting bay was not 'plant' for the purpose of the capital allowances legislation (CAA 2001 ss 21–23). Rogate operated a Renault franchise and its main activity was the sale of new and second-hand cars. As part of its trade, Rogate carried on the specialist activity of applying wax to new cars in a valeting bay (the 'building') at temperatures ranging between 60 and 70 degrees Fahrenheit. Rogate appealed against HMRC's decision to disallow the cost of construction of the building. It was accepted that Rogate carried on a 'qualifying activity'; the issue was therefore whether the valeting bay could constitute 'plant' under CAA 2001.

*Decision:*

Referring to Barclay, Curle & Co (1969) 45 TC 221, the FTT noted that the building did not perform a function (like the raising and lowering of ships in that case). In the present case, the building was a 'workshop designed to allow a glass coat to be applied advantageously'. It was not a tool of the trade but a 'place where people work'. Furthermore, the bay was a 'building' and so fell within the exclusion of s 21 in any event.

**Comments -** The distinction between 'building' and 'plant' for capital allowance purposes has led to many tax disputes as the line is often blurred. This decision may therefore be a useful reference to taxpayers wishing to claim capital allowances on a building/structure.

*Rogate Services v HMRC TC3449*

## Loan relationship scheme fails

The Upper Tribunal (UT) held that a loan relationship scheme marketed by Ernst & Young failed.

Greene King PLC (GKPLC) had lent £300m to another company of the same group, Greene King Brewing (GKB), on which interest was payable periodically and the principal at the end. GKPLC had then assigned to its subsidiary, Greene King Acquisitions (GKA), the right to receive the remainder of the interest (but had retained the right to the capital). GKA had issued preference shares carrying a special dividend to GPLC as consideration for the assignment.

The Greene group contended that GKPLC was no longer taxable on the interest (except for the special dividend of £975,000), GKB was entitled to a deduction on the interest payable (£21.3m), and GKA was only taxable on £768,000 (the difference between the NPV of the interest left to be paid at the time of the assignment and the amount actually received). HMRC argued that GKA was liable to tax on the interest (£21.3m) and that GKPLC should derecognise part of the value of the loans (£20.5m) in its accounts to reflect the fact that it had become a sum in the future without a right to interest. This should then be accredited back over the duration of the loan, generating a taxable profit (of £20.5m). GKB was, however, entitled to a deduction for the interest paid (£21.3m). Like the FTT, HMRC contended that the same amount was effectively taxable twice.

*Decision:*

The UT first considered that the FTT had been right in holding that GKPLC should have derecognised the loan in its accounts. The substance of the transaction was that the loan had become less valuable to GKPLC as a result of the assignment. Secondly, the UT agreed with HMRC that as a result of the accretion (and repayment) of the loan, GKPLC had realised a profit as the amount was received in cash. Thirdly, the UT held that when applying an 'override' or 'reality check', as recommended in DCC Holdings [2010] STC 80, £20.5m did 'fairly represent' (for the purpose of FA 1996 s 84(1)) a profit on the redemption of the loan, and therefore a loan relationship credit. The fact that this may have unintended consequences, as a result of the transaction being part of a purchased scheme, did not change the analysis. Fourthly, the UT held that GKA and GKB did not have a loan relationship, as an assignment of interest without principal cannot give rise to a loan relationship. 'Once the interest is completely divorced from the principal, it no longer has that character (of a loan relationship) between the assignee and the borrower.'

**Comments -** According to the UT, eight or nine similar transactions implemented the scheme. They are all likely to be the object of a double charge to tax. Interestingly, the scheme failed without the need to rely on the TAAR of the loan relationship rules (FA 1996 Sch 9 para 13), which refers to an unallowable purpose.

*Greene King v HMRC (FTC/72/201)*

## Availability of partnership losses

The UT dismissed the claimants' application to quash HMRC's refusal to allow losses allegedly realised in film partnerships to be set off against individual partners' general income.

The partnerships' claims for losses had been challenged by HMRC and a compromise agreement had been entered into allowing losses at a reduced level from that claimed originally by the partnerships. The two taxpayers in the appeal however claimed losses (corresponding to their share of the partnerships' losses) on the basis of the original higher claims of the partnerships. They wished to carry back those losses against earlier income. HMRC wrote to both taxpayers informing them that their self-assessment returns were being amended on the basis of the lower amount of partnership losses referred to in the compromise agreement. In the absence of a right of appeal against HMRC's decision, the taxpayers applied for judicial review. The taxpayers contended that their claims for relief should not be regarded as claims made in a return (to which the procedure set out in TMA 1970 s 8 applied); rather they should be regarded as standalone claims to which TMA 1970 Sch 1A applied, with the effect that HMRC was now out of time.

*Decision:*

The UT considered that HMRC had not commenced an enquiry into the claimants' carry back claims as 'standalone' claims. Instead, it had commenced an enquiry into the relevant partnership returns and partnership statements when they were filed, 'which automatically had the effect of amounting to an enquiry into relevant individual returns of the claimants for the corresponding periods'.

In proceeding in this way, HMRC had proceeded in a lawful manner. The UT added that it would be 'very odd to suppose that Parliament intended to produce an outcome that uncoupled the substantive position and the procedural position'. This would mean that although, as a matter of substance, a partner was only entitled to lower losses, HMRC would have to allow the higher losses as a matter of procedure. The UT also considered that the case could be distinguished from the decision of the Supreme Court in Cotter [2013] UKSC 69. In the present case, HMRC maintained that its enquiry was into the partnership return and the corresponding individual partners' returns for the years in which the partnership losses arose, and was not into the partners' returns for the earlier years.

**Comments -** The claimants' advisers relied on technical arguments which, if successful, would clearly have gone against the legislator's intention. The outcome of the case was therefore predictable. Still, the decision contains a useful analysis of the implications for individual partners of an enquiry, compromise agreement or tribunal decision which concerns the partnership.

*The Queen on the application of De Silva and Dokelman v HMRC (TCCJR/ 10/201)*

## Withholding tax on dividends paid to non-EU funds held unlawful

The CJEU ruled that the levy of withholding tax on dividends paid to investment funds established outside the EU was in breach of European law principles.

The court first noted that the tax treatment of the dividends must be assessed in the light of TFEU art 63 (free movement of capital), not art 49 (freedom of establishment). The national rules at issue did not apply exclusively to situations where the parent company exercises decisive influence on the company paying the dividends. Under Polish corporation tax, dividends paid by a Polish company to an investment fund established outside the EU were subject to a 19% withholding tax at source, whereas those dividends were exempt when paid to a Polish investment fund. The court considered that this difference in treatment may discourage investment funds established in non-member states from investing in companies in Poland, as well as discouraging Polish investors from acquiring shares in non-resident investment funds. The measure was therefore in breach of the fundamental principle of freedom of capital.

Furthermore, the measure did discriminate between 'objectively comparable situations'. The only distinguishing criterion was the place of establishment of the investment fund. The fact that non-resident funds were not part of the EU's uniform regulatory framework (under the UCITS Directive) was not sufficient to consider the situations of these funds to be different. The court noted that a requirement that non-EU resident funds be subject to the UCITS Directive would deprive the principle of freedom of capital of any practical effect. Moreover, the regulatory framework was not referred to in the Polish rules at issue, which focused solely on residence. Additionally, the fact that the system for exchange of information set up by the UCITS Directive does not apply to non-resident funds did not justify the measure, as the Directive did not confer the Polish tax authority with the power to undertake checks on resident investment funds. Furthermore, it could not be assumed 'a priori' that the Polish government was unable to obtain the relevant information from the competent authorities of the USA, given the existence of a tax cooperation agreement between the two countries.

This was a matter for the referring court to decide. Finally, the financial consequences for the Polish government of a judgment against it could not be taken into account by the CJEU to limit its application in time.

**Comments -** The decision is said to open the way for investment funds based outside the EU (particularly those established in the USA and Canada) to reclaim billions of euros in withholding tax levied by EU governments.

*Emerging Markets Series of DFA Investment Trust Company v Dyrektor Izby Skarbowej w Bydgoszczy (C-190/*

## Not a trading receipt but a loan and not taxed

The taxpayer ran a business buying and selling plant and machinery. He opened an account in Guernsey which he disclosed to HMRC in 2007, taking advantage of the department's offshore disclosure facility.

Before accepting the disclosure, HMRC carried out an enquiry into the taxpayer's affairs. This resulted in assessments for income tax, VAT and penalties totaling £500,000 in respect of under declared trading profits and under declared bank interest.

The taxpayer appealed. He said that a credit of £535,478 was a loan to him from his father and not a taxable receipt of the business; further expenses should be taken into account. He also said the penalties were too high.

*Decision:*

On the sum of money described by the taxpayer as a loan, the First-tier Tribunal concluded that “on the balance of probabilities” it was not a trading receipt and inferred that the “origin of the money was as proceeds (probably undeclared for UK tax purposes) of the appellant's father's business activities”. He had been a successful businessman who traded internationally and “had been active in using companies in the Isle of Man to hide … his trading profits and … accumulated wealth”.

In reaching its conclusion, the tribunal said it was aware that the money would “escape tax in the hands of the appellant”, but its job was to determine whether the sum was a receipt of the taxpayer's trade and had found it was not.

Regarding the expenses, the tribunal said the taxpayer's past returns had been inaccurate and the judge noted that the taxpayer accepted that assessments should be raised to cover the undisclosed income. He had produced no evidence to support his expense claims.

Finally, on penalties, the judge said HMRC were correct not to allow the concessionary rate under the offshore disclosure facility and confirmed the sums charged.

The taxpayer's appeal was allowed in part.

**Comments –** Although the funds were probably not declared by the father the tribunal said it was aware that the money would "escape tax in the hands of the appellant", but its job was to determine whether the sum was a receipt of the taxpayer's trade and had found it was not. It is always important to have sufficient records to back up returns to ensure that the position can be defended if necessary.

*J R Swanston v HMRC TC3350*

## Corporate Transparency

**T**he Department of Business Innovation and Skills (BIS) has published a response to comments on the Transparency consultation document published in July 2013.

A key proposal is that that LLPs should be subject to a new regime relating to disclosure of beneficial owners. However, the response document also states that the Government is considering extending the proposal to prohibit corporate directors, subject to limited exemptions, to prohibit corporate members of LLPs as well.

"On balance, we want to ensure - and send a signal - that for the majority of UK companies appointing a company (or legal person) as a director is not an option. Directors should normally be individuals (natural persons). This is a clear change to the UK's approach to corporate transparency and corporate governance.

At the same time we believe we need a pragmatic approach. Corporate directors are considered useful in some parts of the UK economy, particularly areas where, given wider disclosure requirements and regulatory regimes, concerns about corporate transparency and corporate governance are less acute than elsewhere. Throughout these reforms, and in the complementary reforms to Companies House Filing Requirements, we are seeking to implement improvements to the business environment without increasing unnecessary burdens.

We have therefore decided to pursue a default prohibition of corporate directors, whilst additionally providing for limited exemptions to that prohibition. Most companies will not be able to appoint a corporate director. But a company will be able to continue to use or to appoint a new corporate director if it is within scope of the exemptions. We can see a case for consistency and the inclusion of LLPs in this system, alongside companies, and welcome views on this point.

The basis for the exemptions will relate to situations where the use of corporate directors provides particular business benefits, where that coincides with areas of low risk of financial crime, high standards of corporate governance or high levels of disclosure or regulatory oversight. Based on responses to the discussion paper, we are currently considering exemptions applying to:

- Group structures including large listed companies.
- Group structures including large private companies.
- Charities.

We also intend that the use of corporate directors by OEICs (where they are licensed by the FCA), and the use of corporate trustees, should continue. We would be happy to consider scope further as we develop this package for full implementation.

The new position will apply to new director appointments, and to existing corporate directors. To reduce abuse of the UK company structure, it is important we take steps to remove existing corporate directors (outside the scope of the exemptions) from the system.

We will introduce a robust system of compliance to ensure the use of corporate directors is indeed limited. This will include updated requirements to notify Companies House and enforcement thereof, including criminal offences where necessary. To implement these changes, we will bring forward primary legislation as soon as Parliamentary time allows. This will update the current specification that only one director of a company need be an individual (a natural person), and set out the default position of directors being individuals, not companies. We intend to define the exemptions under which an appointment of a corporate director could continue to be made in parallel in secondary legislation.

We propose a one year period for companies to become compliant with the new regime, which we consider should be sufficient given effective advance notice. We will provide more detail in guidance as to how compliance should be achieved, including details of enforcement."

## FRS 102 and intangible assets (Lecture B839 – 9.37 minutes)

*Accounting differences*

FRS 102 is very similar to old UK GAAP with a few of importance differences. Firstly, FRS 102 does not mention the treatment of computer software and web site costs but IFRS for SMEs on which it is based treats them as intangible assets. Old UK GAAP (FRS 15) treated them as tangible assets

Intangibles must be amortised over estimated useful life under FRS 102 - if this cannot be determined then we are told to use 5 years. There is no option to treat intangibles as having an indefinite useful life.

FRS 102 requires recognition of internally created or acquired intangibles if either they are separable (this was the old UK GAAP test), or they arise from contractual or other legal rights. This means a lot more intangibles are capable of recognition under FRS 102 e.g. customer contracts, order books, supply/service contracts at below current market rates, but in practice these would only be recognised if purchased, for example in a business purchase.

*Tax effects for companies*

Goodwill may need to be amortised at a faster rate if the useful life is not known. This will attract accelerated tax relief assuming a trade and its assets were originally purchased as opposed to buying shares in a subsidiary. You need to watch out for connected persons' rules – where the business original started before 1 April 2002, and is then transferred to a connected company, no relief in company for amortisation of goodwill. It is treated as a capital asset rather than an intangible one.

Note that unincorporated businesses never get tax relief for intangible asset amortisation.

*Software and web site costs*

Assuming these are accounted for as intangible assets, then on transition to FRS 102 capital allowances will continue to be claimed for pre-existing software. This means we must disallow the amortisation of what will now be intangible assets in the balance sheet.

New software costs capitalised fall within the Intangible Fixed Assets rules of Part 8 CTA2009. The default is to allow the amortisation for tax purposes, but the company can elect to claim capital allowances instead – s.815 CTA 2009 (will be advantageous if the annual investment allowance is available in particular).

This will create deferred tax and require part-add back of intangible amortisation which can lead to errors

*Example*

JKL Ltd adopted FRS 102 in its year ended 31 December 2015. It capitalised software costs of £350,000 in 2010 and has incurred further costs of £450,000 in 2015. The 2011 software has a book value at 31 December 2014 of £70,000. JKL Ltd has a policy of depreciating software costs over 5 years on a straight line basis.

Explain what adjustments might be made in arriving at the taxable trading profits for 2015.

*Solution*

The 2011 software will continue to attract capital allowances despite the reclassification of the unamortised cost from tangible to intangible assets under FRS 102.

The amortisation of this software for 2015 of £70,000 will be added back to the profits.

If the company makes no election then the £450,000 software costs incurred in 2015 will be treated under the CTA2009 IFA regime – the amortisation and any impairment losses will be tax deductible when recognised. Note that if the company takes this path it will need a comprehensive analysis of the P&L expense for amortisation and impairment so that the correct amounts can be allowed and added back as appropriate.

If the company makes an election under s815 CTA 2009 the amortisation and/or impairment losses would be added back and the company would claim capital allowances instead. This would reduce the risk for error ALL software amortisation and impairment.

*Contributed by Malcolm Greenbaum*

# VAT

## Was a car financing arrangement, with no obligation to buy, a supply of goods?

The UT held that a motor vehicle finance agreement, called 'Agility', was a supply of services (and not a supply of goods as contended by HMRC).

Agility was the product recommended to customers who wished to have the immediate use of a car in exchange for monthly payments, but who were not sure they wished to purchase the car at the end of the arrangement. An Agility agreement therefore shared similarities with both a leasing agreement and a hire-purchase agreement. Whether Agility contracts were supplies of services or supplies of goods determined the way VAT was chargeable on those contracts. If Agility contracts were not supplies of goods, Mercedes- Benz would have to account for VAT on the consideration payable each month. If Agility contracts were supplies of goods, Mercedes-Benz would be liable for the entire consideration payable under the contract upfront (including the amount payable under the option to purchase), and an adjustment would be made if the customer ended up not exercising the option. The VAT due under both analyses was therefore identical but there was a substantial cash flow difference between the two treatments. Under the Sixth VAT Directive (art 14(2)(b)), 'the actual handing over of goods pursuant to a contract for the hire of goods … which provides that in the normal course of events ownership is to pass' is a supply of goods.

*Decision:*
The UT noted that the language of the Directive was not 'apt to extend to all contracts which make provision for the possibility of title passing, or which contemplate it as a normal outcome of the contract, but only where this is the normal outcome'. Furthermore, it was clear that the purpose of the provision was to ensure that contracts for hire where the customers had effectively agreed to buy goods should be taxable as such. This had to be determined at the date of entry into the contracts by reference to the 'economic purpose' of the parties, looking at the 'precise way in which performance satisfies the interests of the parties', as suggested by the advocate general in Tesco [2003] EWCA Civ 1367. The tribunal noted that the contract served the economic interest of the customer by giving him the opportunity to purchase the vehicle without being committed to do so. As for Mercedes-Benz, it received interest during the duration of the arrangement and was neutral on the decision of the customer to purchase the car; it had a contract with another division for the sale of the unpurchased cars. The tribunal concluded that the contract could not be characterised as a contract for the sale of a car as it may or may not lead to a sale. It was therefore not a contract under which ownership was to pass under the normal course of events. The tribunal also considered that this was not an appropriate case for reference to the CJEU, as there was 'a considerable body of guidance on the appropriate approach'.

**Comments -** Although the amount of VAT payable was the same whether the contract was for a supply of goods or a supply of services, the cash flow advantage in having the contract treated as a supply of services justified the appeal. Given that many car manufacturers offer similar flexible arrangements to their customers, this decision is excellent news for the car industry.

*Mercedes-Benz v HMRC (FTC/13/2013)*

## Was a private cab company an agent for its drivers?

The FTT held that fares paid by clients holding accounts with Lafferty and which were passed on to self-employed drivers were not subject to VAT.

Lafferty (trading as Castle Taxis) owned a fleet of cars equipped with radios, which it hired out to independent taxi drivers. The cars did not bear the firm's name and the drivers did not wear uniforms. Customers who had accounts with Castle Taxis would request taxi services, which Castle Taxis would then organise by finding a driver. These customers would be provided with a monthly invoice. Once this invoice was settled, the relevant amount would be credited to the driver after offsetting the mileage payment due for the car. The drivers would therefore bear any bad debts. The key issue was whether Castle Taxis acted as agents for the drivers or as principal. This in turn depended mainly on the relationship between Castle Taxis and the drivers, but the perception of customers did also contribute to the analysis. The tribunal concluded that Castle Taxis simply acted as the collector of the fare money, since drivers were not obliged to respond to requests by customers and bore the risk of bad debt. Castle Taxis therefore acted as agent for the drivers — even though the principals may have been undisclosed. The fares paid by account holders were therefore not subject to VAT.

**Comments -** There are many VAT cases which turn on a similar issue, namely whether an intermediary collecting monies from customers is doing so for its own account or as agent. This decision reminds us that the facts surrounding the actual relationship between the intermediary and the people for whom it collects monies are crucial.

*Lafferty v HMRC TC3493*

## Was dog food a 'meal'?

The Upper Tribunal held that dog food sold by the taxpayer was zero-rated.

Under VATA 1994 Sch 8 Group 1, 'animal feeding stuffs' are zero-rated unless they are 'pet foods … and meals for cats and dogs' (note 6). Notice 701/15/02 provides: 'if a specifically formulated food is held out for sale exclusively for working dogs, it will come within the scope of the VAT relief — unless it is biscuit or meal'. The issue was therefore whether the dog foods sold by Mr Skinner were 'pet foods', in which case they should be standard-rated.

*Decision:*

Agreeing with the FTT, the UT observed that a 'food suitable to be eaten by pet dogs will not necessarily be “pet food” and that whether such a food is “pet food” depends on how it is held out for sale'. Furthermore, the UT considered that packaging was part of the holding out by the supplier, 'but not necessarily the determinative part'. The UT noted that the customer base may be relevant in ascertaining the holding out of the product. The UT concluded that there was evidence supporting the FTT's finding that the food was marketed as 'gundog food'. In particular, the UT rejected HMRC's arguments that the way the food was marketed on leaflets and on the taxpayer's website suggested that the food was pet food. Finally, referring in particular to expert evidence that complete dog food would not be described as a 'meal' but rather as a 'mixer', the tribunal concluded that the term 'meal' in Sch 8 referred to a mixer and so none of the disputed products was 'meal'.

**Comments -** VAT on food has led to much controversy (for instance, after the 2012 Budget) and litigation (see, for example, Procter & Gamble [2009] STC 1990). This case is yet another example of the difficulties of applying the legislation to actual food products.

*HMRC v Roger Skinner (FTC/32/2013)*

## Residential home run commercially and relevant residential purpose

The FTT held that a building hosting a residential home run on commercial lines was not a 'non-residential building'.

Mr Salter and his wife had purchased a building which had been used as a residential home for children since 1950. The children suffered from mental disability or drug addiction. The residential home had been run commercially, the owners being paid either privately or by the local authority. Mr Salter carried out works to the building so as to convert it to an ordinary residential dwelling. He claimed a VAT refund. HMRC denied the claim on the ground that the building had not ranked as a 'non-residential' building prior to the purchase by the taxpayer (VATA 1994 Sch 8 Group 5 note 7A).

*Decision:*

The FTT observed that 'if in the ten years before the conversion the building had been used for a "relevant residential purpose" (naturally another defined term) the building will not have ranked as a "non-residential building" and so no VAT refund will be due on its conversion to a dwelling'. The building had clearly been used for a 'relevant residential purpose' (VATA 1994 Sch 8 Group 5 note 4). It fell within the scope of both paras (a) and (b) of note 4 as a home providing accommodation for children, as well as care for 'disablement' or 'past or present dependence on alcohol or drugs'. Furthermore, the exclusion for hospitals and prisons did not apply; the care provided could not be described as medical care and the children were not committed to any sort of prison or penal institution. The fact that the home was run on a commercial basis did not affect the analysis.

**Comments -** The concept of relevant residential purpose (RRP) has led to a plethora of litigation and guidance by HMRC. This case confirms that, unlike other VAT concepts, the fact that a building is run as a business does not prevent it from being used for a RRP.

*Salter v HMRC TC3556*

## Unreliable records

The taxpayer ran a takeaway food business and was VAT-registered until October 2007. The owner cancelled the registration because he planned to sell the business. But the sale fell through and, on his accountant's advice, the owner did not reregister the business because the turnover was below the registration threshold.

During an investigation, HMRC decided the business records were inadequate, that invoices were missing and sales were understated. As a result, the officer concluded that the business should have been registered from 1 January 2008 to 31 January 2010 and imposed a penalty.

The taxpayer appealed.

*Decision:*

The First-tier Tribunal accepted HMRC's evidence that the business records were unreliable and that the cash register readings did not agree with the taxpayer's handwritten records of daily takings. The judge also accepted the officer's calculations of the takings, although noted that, given these were estimated, they contained a “rough-and-ready element”, but if anything erred on the side of generosity.

The tribunal agreed that the business should have been VAT-registered between 1 January 2008 and 31 January 2010, and confirmed the penalty.

The taxpayer's appeal was dismissed.

**Comments -** Neil Warren, independent VAT consultant, said: “This case involved a concept that is not often considered by HMRC, namely 'liable and not liable'. In other words, HMRC accepted that the taxpayer had no liability to be registered after January 2010 so accepted his liability ended on the latter date, even though he had not formally applied to deregister. The case also highlights the varied techniques that can be used by officers to verify declared takings figures if they feel there is a problem with their credibility.”

*Turgat Karandal (TC3455)*

## Fleming claims: whether HMRC entitled to set-off

The Court of Appeal dismissed the theatre's appeal against HMRC's decision to set off wrongly repaid input tax against VAT wrongly paid by the theatre.

Both the FTT and the Upper Tribunal (UT) had found in favour of HMRC. Under EU law (Sixth Directive Art 13A), member states were required to exempt from VAT 'certain cultural services and goods closely linked thereto supplied by bodies governed by public law or by other cultural bodies recognised by the member state concerned'. The UK had only complied in 1996, six years after the deadline imposed by the directive by inserting a new Group 13 into VATA 1994 Sch 9. HMRC then interpreted the provision restrictively until it was found wrong by the ECJ in 2002 (Zoological Society of London (C-267/00). This meant that the theatre had a Fleming claim ([2008] UKHL 2). The theatre's claim for repayment relied on the principle of EU law that a provision of a directive that is both unconditional and sufficiently precise may be relied on before the national courts by individuals against the state in two ways: where the latter has failed to implement the directive in domestic law by the end of the period prescribed; or where it has failed to implement the directive correctly.

*Decision:*

The court observed that, if the UK had implemented the directive properly by the deadline of 1 January 1990, from that date the theatre would not have charged VAT on its supplies of tickets and it would not have been entitled to credit for input tax. Agreeing with HMRC, the court considered that the theatre must therefore be put into the position it would have been if the UK had correctly implemented the directive. 'It must take the rough with the smooth.' VATA 1994 s 81 (the set-off provision) should therefore be interpreted to achieve this result because any other conclusion would unjustly enrich the theatre.

The purpose of s 81(3A) was 'that where a taxpayer makes a claim for repayment of VAT which has been paid owing to a mistake, all the consequences of the mistake are to be taken into account in assessing the quantum of his claim. That purpose is consistent with the overarching scheme of VAT under the sixth directive which treats the payment of output tax and the deduction of input tax as an “inseparable whole”.' The court also rejected the theatre's arguments based on the three EU law principles of effectiveness, equality and certainty. The court noted that HMRC's right of set-off did not prevent the theatre making its claim, and so the principle of effectiveness was not breached. Referring to Ecotrade SpA v Agenzia delle Entrate (C-95/07 and C-96/07), the court emphasised that the taxpayer and the taxing authority were not in comparable positions and so the principle of equality was not affected. Finally, the principle of legal certainty was not a trump card (Amministrazione dell'Economia e delle Finanze and Agenzia delle entrate v Fallimento Olimpiclub Srl (C-2/08)). It was subject to the other two principles. Furthermore, it was up to the taxpayer whether to make the claim and to decide which accounting periods to put into his claim. The key was that the taxpayer voluntarily subjected himself to the statutory process. HMRC did not initiate the process and so certainty was not in point.

Finally, the court addressed the UT's concern that HMRC might seek to consider accounting periods for which the taxpayer had no obligation to keep records. The court felt that this was not an issue. In such circumstances, HMRC would have the evidential burden of establishing that set-off was appropriate, which the taxpayer would then have to rebut. It would be open to the tribunal to make allowances for the taxpayer.

**Comments -** The calculation of the quantum of Fleming claims seems to continue to cause a plethora of litigation. This case not only sets out the approach of the courts to set-off by HMRC, it also usefully recaps the story so far.

*Birmingham Hippodrome Theatre Trust v HMRC (A3/2013/1012)*

## VAT on discounts and credits (Lecture B840 – 11.47 minutes)

*Prompt payment discounts*

A reduced amount of VAT has always been charged on a supply where prompt payment discount was offered by the supplier, even when the discount was not taken up by the customer.

*Example*

John is a VAT registered builder and has fitted a new boiler for Janet for a fee of £4,000 plus VAT. He has offered Janet a 5% discount if she pays within 14 days of the invoice date. John's invoice will be raised as follows:

| | |
|---|---|
| Installation of new boiler | 4,000 |
| VAT at 20% | £760 |
| Total amount due | 4,760 |

Payment terms: 5% settlement discount 14 days.

In the above situation, John is allowed to charge VAT on the discounted amount ie £4,000 x 95% x 20%, irrespective of whether Janet takes advantage of the discount. John must clearly show the discount terms on his invoice.

In effect, Janet will pay 19% VAT on the work carried out if she doesn't take advantage of the discount – and a correction of this outcome was announced in the Budget, namely that legislation will be introduced to ensure that VAT is accounted for on the full consideration paid by the customer ie £4,760 x 1/6 = £793.33.

- The proposals will be subject to consultation and will commence for the majority of businesses on 1 April 2015
- However, for business-to-consumer supplies of telecom and broadcasting services (where HMRC has particular concerns about VAT losses) the new rule will come in on 1 May 2014
- HMRC could bring forward the general 1 April 2015 introduction date in other cases where they identify a potential loss of tax revenue

What do the proposals mean in practical terms? They basically mean that if a business takes no action after an invoice has been raised, where prompt payment discount has been offered, then it has an extra output tax liability if the customer does not take advantage of the discount ie . So in the example above, extra output tax of £33.33 is payable by John ie £793.33 less £760.

However, John could make it a condition of trading that Janet must pay an extra £40 VAT if she does not take advantage of the discount ie output tax of £800 for John so that there is no loss of margin for him.

He can then support the charge by issuing her a VAT only invoice for £40. However, another potential outcome is that many businesses might decide to stop offering prompt payment discounts to their customers.

According to HMRC, about 250,000 businesses could be affected by the change with an initial cost of £8m implementing the changes to IT systems and internal procedures, followed by an annual cost of £3.5m for each of the next four years.

*VAT credits on manufacturer rebates (1 April 2014)*

UK law allows a business in a direct relationship with a customer to adjust the VAT originally accounted for in the case of a post-supply adjustment to the payment initially made by the customer. However, the legislation is silent on the position where a manufacturer, which has no direct relationship with the final consumer of its products, makes a post-supply payment.

With effect from 1 April 2014, manufacturers can now adjust their VAT to take account of refunds they make to final consumers. In this context the term 'refund' refers to a payment made by a manufacturer directly (or via a third party) to the customer of a retailer. These payments may be made for a number of reasons, for example:

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

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

However, sometimes the purchaser seeks a refund of some, or all, of the price paid for the goods from the manufacturer and not from the retailer eg when there is a major fault in the goods. Regulation 38 now deals with this situation.

The new legislation also makes express provision for adjustments where the first supplier (manufacturer) reduces the price paid by the final consumer under the terms of a business promotion scheme involving cashbacks or money-off coupons where the manufacturer reimburses the retailer who has accepted the money-off coupon from the final consumer. The measure seeks to equalise the VAT treatment as far as possible and ensure that UK law expressly accords with EU law.

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

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

Note - the change was made by amending the Value Added Tax Regulations 1995 (1995/2518) – insertion of new Regulation 38ZA.

*Intended outcome*

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

*Key points*

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

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

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

- Payments made to the customer or third parties to cover the cost of repairs to the goods sold by the manufacturer will not be covered by the changes. HMRC felt that this measure would go beyond the intentions of the EU VAT Directive.

*Contributed by Neil Warren*