

Business tax round up

(Lecture B1136 – 17.18 minutes)

Personal company for entrepreneurs' relief

Summary - when deciding whether a company is a personal company for entrepreneur's relief, the 5% ordinary share capital test means 5% of the nominal value of the issued shares.

Philip Hunt is a Chartered Accountant. In early 2007 he was approached by the Chairman of Foviance Group Ltd, a specialist web usability and analytics business. At that time, Foviance Group Ltd's issued share capital was divided into shares with a £1 nominal value.

Philip Hunt agreed to take over as Chairman, and to invest £50,000 in the company in exchange for shares. Foviance Group Ltd's lawyers advised that he subscribe for shares with a 10p nominal value, as this would be more straightforward than obtaining the permission of existing shareholders to issue new £1 shares. Over the following years his shareholding increased as the result of further investments. Share buybacks, share options and a merger also changed his position in relation to the other shareholders.

In 2014, Foviance Group Ltd decided to seek a buyer, and on 13 August 2015 all the shares were sold to Ernst & Young. On that date Philip Hunt owned:

- 5.94% of the total shares issued;
- 4.16% of the nominal value of those issued shares; and
- 6.21% of the total number of votes attributable to the issued shares.

In the course of the sale negotiations, EY had pointed out to Philip Hunt that his shareholding might not qualify for entrepreneurs' relief, because he did not hold at least 5% of Foviance Group Ltd's nominal share capital. They suggested he might wish to "recapitalise" his 10p shares so that they became £1 shares, and then wait for a year so that the ER minimum holding period was met. However, he decided that a prompt sale was in Foviance Group Ltd's best interest, and did not delay the transaction.

In due course he completed his SA return claiming entrepreneurs' relief on his share sale.

HMRC opened an enquiry, having decided that Philip Hunt was not entitled to entrepreneurs' relief, and increased the tax due by £225,451.96; this figure was subsequently reduced to £199,751.

Philip Hunt appealed to the First Tier Tribunal.

Decision

The dispute turned on the whether the shares that Philip Hunt held were in a “personal company” as defined at TCGA s 169S(3) which states that he needed to hold: –

- “(a) at least 5% of the ordinary share capital of which is held by the individual, and
- (b) at least 5% of the voting rights in which are exercisable by the individual by virtue of that holding.”

Since he held more than 5% of the voting rights, the issue was with the phrase “5% of the ordinary share capital”. HMRC’s view was that this meant 5% of the nominal value of the shares in issue but what did the First tier Tribunal find?

The First Tier Tribunal stated *Canada Safeway [1972]* established the meaning of ordinary share capital which was simple and workable; the statutory phrase was 'issued share capital' not 'issued shares'. In both TCGA 1992 and the Companies Act 2006, share capital is divided into shares where each has a fixed nominal value meaning that the 5% test for entrepreneurs’ relief refers to 5% of the total nominal value of a company's share capital.

The appeal was dismissed.

Philip Hunt v HMRC (TC07057)

Preference shares and entrepreneurs’ relief

Summary – Cumulative preference shares represented part of a shareholder's ordinary share capital for the purpose of entrepreneurs' relief.

Stephen Warshaw was chairman of Cambridge Education Group Limited. Prior to 12 March 2012, he held 44,183 ordinary shares and 396,000 preference shares in Cambridge Education Group Limited.

Following a group reorganisation in March 2012, Stephen Warshaw exchanged these old shares for new shares in a new company, Cambridge Education Holdings (Jersey) Limited. As a result of these changes, Mr Warshaw’s shareholding in the new company replicated his original shareholding

On 26 March 2012, he subscribed for 24,660 B ordinary shares in the new company and became a director on 26 October 2012.

On 4 December 2013, he disposed of his entire shareholding for cash and ceased to be a director from that date.

On 28 January 2015, he submitted his 2013/14 self-assessment tax return, including a capital gains computation for the disposal of the shares totalling £6,438,419, and a claim for entrepreneurs’ relief in respect of the disposal.

On 5 October 2015, HMRC opened an enquiry into the return and later, in August 2017, issued a closure notice denying the entrepreneurs’ relief claim.

The rights attaching to the various classes of shares in the new company were set out in its Articles of Association. The preference shares were cumulative; if there were insufficient reserves to pay the dividends in respect of those shares in a particular year, payment was deferred to a subsequent year. This meant that the rate at which the dividend would be paid, 10%, would be calculated as the aggregate of the subscription price and the total unpaid dividends. The issue came down to how the preference shares were to be treated. In summary, if the preference shares were 'ordinary share capital' (as defined in ITA 2007 s 989), Mr Warshaw held 5.777%. However, if the preference shares were not 'ordinary share capital', he held only 3.5%.

- HMRC argued that as the rate at which the dividend was paid on the preference shares was fixed at 10%, there was 'a right to a dividend at a fixed rate' and so the shares were should not be treated as ordinary share capital.
- Stephen Warshaw appealed arguing that because the rate of dividend is calculated by reference to any previous unpaid dividends, the preference shares did not have a right to a dividend at a fixed rate.

Decision

The First Tier Tribunal agreed with the taxpayer that the decision of Vinelott J in *Tilcon v Holland* offered some support. In reaching their decision they must take into account both the percentage element and the amount to which that percentage is applied.

In this case, under the Articles of Association, only the percentage element was fixed. The amount to which that fixed percentage was to be applied could vary.

Consequently, the preference shares could not be regarded as having a right to a dividend at a fixed rate and were therefore ordinary share capital as defined by s 989 ITA.

The appeal was allowed.

Stephen Warshaw v HMRC (TC07107)

MTD pilot for income tax

As part of the Making Tax Digital pilot, certain taxpayers can voluntarily use MTD compliant software to keep their business records digitally and send Income Tax updates to HMRC, instead of filing a Self Assessment tax return. This pilot is now open to landlords with income from furnished holiday lettings, together with other UK-resident landlords and sole-trader businesses. Does this mean that landlords with furnished holiday lets will be among the first businesses that will be required to submit tax details through MTD when it goes live?

By taking part in the trial, taxpayers will become familiar with what is required under the MTD system at a time when HMRC are hopefully able to offer greater support.

To take part in the pilot, taxpayers must be UK resident and be up-to-date with both Self Assessment returns and tax payments. They can sign up using their Self Assessment online service Government Gateway user ID and password.

Once their MTD compliant software is functional, HMRC will remind them to send their Income Tax updates every quarter as well as a final report. The deadline for this report will depend on the tax year that the accounting period ends in.

Example 1 - Accounting period is 6 April 2019 to 5 April 2020

Assuming a taxpayer signed up for the pilot on 6 April 2019 they will send their:

- 2018/19 Self Assessment tax return as usual so by no later than 31 January 2020
- Four Income Tax updates under MTD, the last one by 5 May 2020;
- Final report will be due by 31 January 2021.

Example 2 - your accounting period is 1 May 2019 to 30 April 2020

Assuming a taxpayer signed up for the pilot by 1 May 2019, they will send their:

- 2018/19 Self Assessment tax return as usual so by no later than 31 January 2020;
- 2019/20 Self Assessment tax return as usual so by no later than 31 January 2021;
- Four Income Tax updates under MTD, the last one by 31 May 2020;
- Final report by 31 January 2022.

www.gov.uk/guidance/use-software-to-send-income-tax-updates

Late registration

Summary - Following some favourable assumptions, the VAT charged for late registration was reduced and the penalty cancelled.

Daniel Potts, a plumber, filed his 2014/15 tax return in January 2016. This contained self-employment pages showing turnover as £93,274. The self-employment pages informed HMRC that he should be VAT registered.

Following a VAT review by HMRC, they concluded that Daniel Potts should have been registered by 1 October 2014. This was based on calculations taking the annual turnover as shown on the income tax returns and dividing it by 12 to give equal monthly figures. However, based on a detailed breakdown of actual sales it was clear that the registration date should have been earlier on 1 July 2014.

HMRC issued a penalty assessment of £1,664.60 for failing to register for VAT at the correct time representing 20% of the lost tax

Decision

The First Tier Tribunal stated that they were aware that late registration for VAT for a person whose customers are private individuals and not VAT registered can produce very harsh consequences as in this case, where Mr Potts was unable to collect the VAT that he should have charged. In the light of this and within the bounds of the law, the Tribunal stated that they had made a number of favourable assumptions about things being done in time, or at all, which led to reduced VAT being charged as well as the penalty being cancelled.

The Tribunal considered if there was any basis on which they could revert to HMRC's initial figures. Had Mr Potts had another accountant or if he had had no accountant at all, he might have said to HMRC on receipt of their figures that he accepted them and should be liable to be registered from 1 October 2014 as HMRC's calculations showed. In these circumstances the Tribunal felt that they could and should vary the decision by saying that the effective date of registration was 1 October 2014.

As for the penalty, the maximum penalty for a failure that was not deliberate (as HMRC conceded was the case here) is 30% of the potential lost revenue.

A penalty may be mitigated from the maximum down to a minimum with that minimum being one of three amounts (20%, 10% or nothing):

- 20% for a prompted disclosure where HMRC became aware of the failure 12 months or more after the time when the tax first became unpaid by reason of the failure (10% if HMRC aware less than 12 months after that time);
- 10% for a unprompted disclosure where HMRC became aware of the failure 12 months or more after the time when the tax first became unpaid by reason of the failure (0% if HMRC aware less than 12 months after that time).

So was the disclosure prompted and when did they become aware of the failure?

Mr Pott's accountant said that he completed the tax return clearly stating that the turnover was over the limit and registration was required, and that HMRC "tacitly" accepted that 10% was correct. The Tribunal accepted that HMRC were told of the failure before they had reason to be aware of it, and so the minima for unprompted penalties applied.

HMRC were made aware when the return was filed before the end of January 2016 (The final issue is on what date did "the tax" first become unpaid by reason of the failure. Every person who is required to be registered for VAT (but who is not) is required to make a return for each quarter no later than the end of the month following the end of the quarter. In this case Mr Potts was required to pay VAT for Q4 2014 by 31 January 2015, for Q1 2015 by 31 March 2015 and for Q2 2015 by 31 July 2015. It followed that HMRC became aware of the failure within 12 months of the tax unpaid date for all periods, the penalty was a minimum of 0%.

The First tier Tribunal decided that Mr Potts should have been registered for VAT from 1 October 2014 rather than 1 July 2014, and they cancelled the penalty.

Daniel Potts v HMRC (TC07076)

Direct debit mistake

Summary – A 15% default surcharge penalty was discharged. The company had a reasonable excuse for believing that payment would be collected by Direct debit.

In October 2016, a customer of Norfolk Premier Coachworks Limited became insolvent leaving the company with a bad debt that was subsequently assessed as £160,000. Understandably, that caused significant cash flow problems for the company.

The company had various time to pay arrangements with HMRC and other creditors and gradually got back on its feet. The company believed that the payment for period 12/17 would be made on time by Direct Debit and when it was discovered that it had not been, took steps to pay the VAT due as soon as possible. The company argued that a penalty of 15% for a two day delay seemed to be unfair and disproportionate.

HMRC stated that genuine mistakes, honesty and acting in good faith are not usually considered reasonable excuses for surcharge purposes, unless it can be shown that in the particular circumstances concerned, the actions of the trader were reasonable.

Whether there is a reasonable excuse depends on the particular circumstances in which the failure occurred and the particular circumstances and abilities of the person who failed to file their return on time. The test is to determine what a reasonable taxpayer, in the position of the actual taxpayer, would have done in those circumstances and, by reference to that test, to determine whether the conduct of the taxpayer can be regarded as conforming to that standard.

Decision

The First Tier Tribunal accepted that Mr Steward, company director genuinely believed that the payment of the VAT due for period 12/17 would be taken from NPCL's bank account by Direct Debit on 7 February 2018. Mr Steward had taken out personal borrowings to ensure that the company had the money to pay HMRC so why deliberately leave that money sitting in its bank account. The Tribunal stated that it is clear from Perrin that a mistaken belief can be a reasonable excuse if the belief was objectively reasonable. The Tribunal concluded that this was the case here.

Norfolk Premier Coachworks Limited had paid amounts of VAT due to HMRC by National Direct Debit Service/System ("NDDS") in August and September 2016 and February, March, April, May and June 2017. The NDDS is a direct debit system used for specified amounts and dates. Despite the company being informed that a separate Direct Debit had been cancelled, payments of VAT continued to be made via NDDS. The Tribunal considered that it was understandable that a person such as Mr Steward might have failed to appreciate the distinction between a Direct Debit and the NDDS. The confusion meant that he might reasonably have believed that the Direct Debit had been reinstated because the company continued to make payments by the NDDS after that date. In fact, the Tribunal accepted that Mr Steward did not know about the letters cancelling the Direct Debit. Importantly, once he became aware of the situation on 9 February 2017 (and the reasonable excuse ended), Mr Steward took steps to pay the VAT due without unreasonable delay on the same day.

Norfolk Premier Coachworks Limited's appeal was allowed and the default surcharge penalty for period 12/17 discharged.

Norfolk Premier Coachworks Limited v HMRC (TC07126)

New build granny annexe

Summary – The granny annexe built in the grounds of an existing property qualified as a new build eligible for the DIY refund scheme.

The property, 15 Pelham Road, is owned by Tristin Swales, the son of the appellant, Christopher Swales. He wanted to create separate accommodation for his parents in the grounds of the property and applied for planning permission to do so on land located close to the existing house, where a shed was located.

On 23 March 2015 the council granted approval for “Erection of extension to outbuilding and conversion to residential annexe at 15 Pelham Road ...”. There were no conditions in the planning approval relating to the sale or use of the new building. Nor was there anything in it that required the retention of any of the walls of the shed.

The work started in April 2016 and lasted 35 weeks. Nothing of the original shed remained except the concrete floor slab. That slab was not used as the base for any part of the new building, as a floating slab covering the whole footprint of the new building was installed and from which piles were sunk into the ground.

Having contacted HMRC, the Swales were advised that if they were building the house themselves, they may be able to take advantage of the DIY builders refund scheme (S35 VATA 1994). Under this scheme they might be eligible to claim back the VAT on building materials purchased.

However, on 31 May 2017 HMRC refused this claim and, following an upheld review, the case proceeded to the First Tier Tribunal.

The grounds for rejection of the refund were nowhere explicitly stated, but reading between several lines the Tribunal concluded that these grounds were that what was constructed was not a “new build” but an extension of an existing building because a building constructed on the site of an existing building cannot incorporate any part of that existing building above ground level. The Tribunal assumed that this was a reference to Notes 16 (c) and 18 Group 5. However, at the start of the appeal hearing it was agreed that the only issue still in dispute was whether the construction work completed was within the scope of Note 2(d) Group 5 Sch. 8 VAT 1994.

Pulling out the key bits of legislation considered by the Tribunal:

Note (2) states:

“A building is designed as a dwelling or a number of dwellings where in relation to each dwelling the following conditions are satisfied—

(d) statutory planning consent has been granted in respect of that dwelling and its construction or conversion has been carried out in accordance with that consent.”

Note 16 (c) states:

“For the purpose of this Group, the construction of a building does not include—

(c) the construction of an annexe to an existing building.”

Note 18 that states:

“A building only ceases to be an existing building when:

(a) demolished completely to ground level; or

(b) the part remaining above ground level consists of no more than a single façade or where a corner site, a double façade, the retention of which is a condition or requirement of statutory planning consent or similar permission.”

Decision

The First Tier Tribunal considered Note 2(d). HMRC had argued that the plans showed the retention of three of the original walls so the planning permission given was for work on an existing building.

However, no one at the council was under the impression that the three walls were to be retained and certainly not that it was a condition of the planning consent that they must be. Demolition was to be to ground level. Indeed retaining the walls would itself have made the works unlawful under the Building Regulations.

The walls were not retained so Note 18 had the effect that in law the shed ceased to be an existing building, even though the slab was retained and built over.

The condition in Note 2(d) had been met and the refund claim was allowed.

Although not necessary to this appeal, the Tribunal went on to consider Note 16(c) and whether a refund could be denied as the construction was of an annexe. The Tribunal said that, if called upon to decide, they would have no hesitation in saying that the new property was not an adjunct or accessory to the main house. The gap of over 40 metres is sufficient to show that the property is not an annexe. The terms of the planning permission did not prohibit separate sale or disposal, and although it did use the term “annexe” the Tribunal did not agree that this term in the planning permission must be construed by reference to its meaning in Note 16 of Group 8. The couple were looking for as much independence as possible in a self-contained building and to get out from under the feet of their son Tristin.

Christopher Swales v HMRC (TC07116)

Making tax digital for VAT

On 3 May HMRC updated Notice 700/22 that gives guidance on Making Tax Digital for VAT. Of particular interest is the new guidance on the use of supplier statements, petty cash transactions and charity fundraising events.

Supplier statements

Businesses receiving a large number of invoices from the same source often record the value of supplies from a supplier statement rather than from individual invoices. HMRC will now accept the use of supplier statement totals but only if all of those supplies are included on the same return and the total VAT charged at each rate is shown. Businesses must show the appropriate audit trail by cross-referencing all items listed to the invoices received, somewhere in their records.

Petty cash

Where a business uses petty cash to pay for small value items, these do not need to be individually recorded in the digital records. The business can record the total value and the total input tax allowable. This applies to individual purchases with a VAT-inclusive value below £50 and the total value of petty cash transactions recorded in this way cannot exceed a VAT-inclusive value of £500 per entry.

Charity fund raising events

Charities can find it difficult to meet the digital record-keeping requirements for volunteer run events due to the large number of supplies needing to be recorded on a VAT return. The guidance now states that, where supplies are made or received during a charity fundraising event run by volunteers, charities may treat all supplies made as covered by one invoice for the event, and all supplies received as covered by one invoice for the event.

<https://www.gov.uk/government/publications/vat-notice-70022-making-tax-digital-for-vat>