THE
CHARTERED
INSTITUTE OF
TAXATION

CIOT/ATT East Midlands Branch

"Advising the Self-Employed"

Presented by Dean Wootten

Date: Wednesday 23 September 2009

Venue:
The Premier Travel Inn
Braunstone Lane East
Leicester

Timetable:
4.00pm - Refreshments and registration*
4.30pm – Lecture begins
6.00pm – Break for refreshments*
6.30pm – Lecture resumes
7.45pm - Questions
8.00pm – Close

CPD Hours: 3
*Refreshments sponsored by:

Beeston Business Centre, Technology Drive,
Beeston, Nottingham. NG9 2ND
Telephone 0115 9227107
www.itmakessense.net
sendmeinfo@itmakessense.net

Disclaimer
These notes are an aide memoire for general information only. No responsibility for loss occasioned to any person who acts or refrains from acting as a result of reliance on any information in this material can be accepted by Dean Wootten, CIOT or ATT. Specific professional advice should be taken before deciding on the best course to follow in any particular case.

ADVISING THE SELF EMPLOYED

23 SEPTEMBER 2009

CONTENTS –

1. Self employed v employed status issues 3
2. Incorporation and Disincorporation 10
3. Why are corporates better? 18
4. Finance Act 2009 and the self employed 23
5. Relief for Capital Expenditure 33
6. Wholly and exclusively 38
7. Do tax credits matter? 51
8. The impact of the new penalties regime on the self employed 58

Speaker: Dean Wootten FCA CTA

Whilst every care has been taken in preparing these notes, no responsibility for anyone acting upon or refraining from acting upon these notes can be accepted.

© Copyright Reed Elsevier (UK) Ltd. 2009. All rights reserved

1. Self employed v employed status issues

1.1 Introduction

The self employed v employed status debate affects many different areas of our client base:

- our self employed client engaging self employed contractors (are they really self employed or does your client have PAYE obligations?)
- our self employed clients working in the construction industry (are they really "self employed")
- our service companies and the application of the intermediaries legislation (commonly known as "IR35")

Whilst status affects a wide variety of situations the issues raised in case law are generally applicable to all.

1.2 Recent cases on employment status issues

1.2.1 Dragonfly Consultancy

The case of *Dragonfly Consultancy v HMRC* received a lot of publicity when it was heard at the Special Commissioners and in itself was a good case to read if you wanted to get up to date on recent employment status cases, plus older ones that still have a relevance (see SpC 655). The facts were based around the controversial IR35 (intermediaries legislation) rules. The case has now reached the High Court [2008] EWHC 2113 (Ch). although once again the taxpayer has lost.

The facts

Dragonfly Consultancy Ltd employed its owner, an IT consultant. Dragonfly contracted with an agency, which in turn had a contract to supply workers to an end client (the AA). The Special Commissioners held that had the consultant been in a direct contractual relationship with that client it would have been an employment relationship. Therefore IR35 applied. Dragonfly appealed.

In dismissing the appeal the Court made some interesting comments. Firstly, it found that the Special Commissioners were entitled to find that the substitution clause in the consultant's notional contract with the client would not have been such as to preclude an employment relationship. Unfortunately there was an actual substitution clause in the agency contract with Dragonfly but this was not mirrored in the agency contract with the AA. Consequently substitution was not a factor in this case and it would be decided on other issues. The main reason this case failed was "control". The taxpayer was under the day to day control of the AA. He was not told how to do his work (specialists rarely are) but he was told what to do and when to do it by. In the Commissioners view the level of control exercised by the AA was indicative of an employed relationship.

The High Court held that the Special Commissioners were entitled on the facts to hold that the degree of control exercised by the end client equated to that under an employment contract and the taxpayer had not provided sufficient evidence otherwise. Dragonfly Consulting is left facing a tax bill for £99,000.

Analysis

This case has been long awaited and there are strong views on either side about the facts. Some would argue that there was limited evidence that the taxpayer was really working on his 'own account' and others contend that he was patently distanced from the AA and working for himself. However, what is clear is that the facts as brought out failed to convince the Special Commissioners and the High Court that the taxpayer was outside of IR35.

One element of this was the inability of the taxpayer to show that he had a genuine substitution clause and it once again shows that although it is not technically essential, it certainly helps if those with such a clause in their contract use it on at least one occasion to show that it is capable of being used.

1.2.2 Sherburn Aero Club Limited

The appellant company, a flying club, engaged flying instructors to provide tuition to members at its premises and in aircrafts owned by it. All the instructors engaged by the company were added to the list of approved instructors following an interview with the Chief Flying Instructor (CFI) and although some of the instructors had written contracts setting out their terms of engagement, others did not. The instructors notified the company in advance of the dates and times when they would be willing and available to provide instruction, although they could change their mind about their availability even at very short notice. They were also free to work elsewhere. They were paid on the basis of a standardised hourly rate and the actual rate depended on the type of instruction being given. The instructors had to follow the syllabus laid down by the Civil Aviation Authority ("CAA") and they were subject to the flying orders set out in the Flying Order Book. The company treated all the instructors as self–employed contractors. In 2007 HMRC issued determinations under the Income Tax (Pay as You Earn) Regulations 2003, SI 2003/2682, reg 80 for the years 2005–06 and 2006–07 on the basis that the instructors were employees. HMRC also issued notices of decision of national insurance contribution liability under the Social Security (Transfer of Functions) Act 1999, s 8 for the same years. The company appealed contending that the relationship between it and the instructors was one of a contract for services as the three conditions, as laid down in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497, necessary for a contract of service to exist—and described by the Court of Appeal in *Montgomery v Johnson Underwood Ltd* [2001] EWCA Civ 318, [2001] ICR 819 as the "irreducible minimum for a contract of employment to exist"—were not met in the present case as, inter alia, (i) there was no obligation on the instructors to perform a given flying slot even if they had already indicated that they could do it. On the basis of the lack of mutuality as part of the "irreducible minimum" the instructors could not be employees; (ii) although the instructors usually performed the services themselves, it did not negate the existence of a right to provide a suitable substitute. The important issue was the existence of such a right, rather than the extent to which it was actually used; (iii) there was insufficient control by the company over the instructors to amount to a master/servant relationship. Control was part of the irreducible minimum required to create a contract of employment and the requisite element was missing here. HMRC submitted that the instructors were engaged by the company under contracts of service. The control test might not be decisive, particularly in the case of skilled workers, like the instructors, who had the discretion to decide how their work should be done. On the evidence the relationship between the company and the individual flying instructors met the "irreducible minimum requirements" for those relationships to be contracts of service for the following reasons—(i) there were contracts between the company and the instructors; (ii) the instructors were offered work by the company and undertook the work for payment, and the offer and performance of work for remuneration constituted a contract between them, thus meeting the mutuality of obligation test; (iii) the flying instructors were highly skilled workers yet were subject to the control of the company while performing their duties for the company—that control was sufficient for the contracts between the company and the instructors to be contracts of service; (iv) the instructors were required to provide personal service; and (v) the instructors were not in business on their own account when performing their duties for the company and bore no financial risk.

The Special Commissioner considered that the "irreducible minimum" was not intended to refer to all three of the conditions necessary to establish a contract of service, only to the "mutuality of obligations" element of the first condition with the result, in particular, that the second, "control", condition fell outside the irreducible minimum. Thus the "irreducible minimum" referred solely to the question of mutuality and did not extend to the other conditions. Whilst on that view, the factors of personal service, control and other provisions of the contract were not part of the irreducible minimum their importance was in no way diminished. It remained necessary to examine the facts relevant to the particular contract against each of those conditions in order to arrive at a conclusion on its nature, and it might be necessary to make other enquiries before it was possible finally to determine the question. Furthermore, the second condition, namely "control", was control of a particular type which was in question; the worker "agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make that other master." The control had to relate to the performance of the service. It also had to be of a type,

quality and extent to result in the relationship being that of employer and employee. It was the right of control that mattered; not whether it was actually exercised. The third condition related to what happened in practice in establishing the true nature of the relationship between the parties.

Applying that approach to the facts of the present case, the Special Commissioner found that the flying instructors engaged by the company during the relevant period were engaged under contracts for services and were thus not employees or employed earners. On the facts the "mutuality" condition was met in respect of the individual engagements actually undertaken by the flying instructors, and the choice left to them on their part whether to accept further engagements and the choice on the company's part whether to offer them further engagement was not relevant in determining whether the condition was met in relation to the specific engagement. However, the fulfilment of that condition did not decide the nature of the relationship for that specific engagement. The "personal service" element of the first condition was also fulfilled. The company had to ensure that any person providing instruction to its members had the appropriate level of qualifications to meet the requirements imposed by the CAA for the training in question. Substitution in the instant case amounted to selection of another approved instruction from the "pool" available to the company and was not a real form of substitution. The absence of real substitution did not affect the conclusion on the "personal service" condition. The need to ensure appropriate qualification meant that engagements had to be personal. However, the various elements of the "control test" were not met for the following reasons—(i) the company was not in a position to dictate to the instructor what work needed to be done as the instructor could withdraw from the booking; (ii) the company did not exercise control over the way in which the work was done; (iii) the company had no power deciding the means to be employed in carrying out the work. The syllabus was laid down by CAA and there was no scope for the company to make any decisions in relation to it; (iv) the company was not able to control the decision as to place and as the hallmark of the relationship was flexibility on both sides and as the casual nature of the arrangements meant that the engagements had to be viewed as a series of short–term engagements rather than as a longer term relationship between each instructor and the company, the company did not have control as to time under the terms of a contract. It followed that the second condition was not fulfilled in the present case. Although control was not part of the "irreducible minimum", it was clear that in order for a contract to be one of service, the three conditions all had to be fulfilled. On that basis, the engagements between flying instructors and the company were not contracts of service and the company's appeals had to be allowed. Appeals allowed.

1.3 False self employment in construction: Taxation of workers

Status of workers in the construction industry has always been an issue as far as HMRC are concerned – are the workers employed or self-employed?

In July 2009 HMRC published a consultation document on construction workers. It would appear that many workers in the construction industry are falsely self-employed and HMRC would like to rectify this problem!

The introductory chapter of the document sets the scene:

'The Government has concluded that the best way to address this issue of false self-employment for income tax and National Insurance contributions [NICs] purposes is to introduce legislation, which deems workers within the construction industry to be in receipt of employment income unless one of three simple, clear and easy to apply criteria… is met. If the worker is deemed to be in receipt of employment income, pay as you earn (PAYE) and NICs will be due on the payment he receives.'

So it is barely a consultation as the rules seem to have been agreed internally by HMRC!

The solution to their "problem" is to deem every construction industry subcontracting worker (the genuinely self-employed as well as the falsely self-employed) to be in receipt of employment income for all tax and NIC purposes – unless they can satisfy <u>one</u> of the three 'key tests'.

The key tests

The document suggests that there are three 'reliable indicators, within the context of the construction industry, of a worker being in receipt of self-employment income'. These are the provision, by the worker, of:

- plant and equipment that is required for the job, but not including the traditional and normal 'tools of the trade' that individual workers usually provide;
- all the materials required to complete a job; and
- other workers to carry out aspects of a job, but only where the worker is personally responsible for paying them.

If a worker can meet any one of these tests he will not be deemed to be in receipt of employment income for the engagement in question. It is presumed that the tests will have to be applied to each engagement undertaken by a worker.

Part of the argument put forward for the use of these key tests is that if any one of the tests were brought to a tribunal as evidence, and it could be demonstrated that it applied to the taxpayer, it would be heavily indicative of self employment .

Where the three test argument is flawed is that recent case law considers many different factors but the most important has recently been held to be control – which is not one of the three tests!

Consider the recent judgement in *Wright v Revenue and Customs Commissioners TC32.*

The appellant undertook work on a sub-contract basis for main contractors and used his own workers in doing that work.

HMRC considered these workers were employees and raised assessments under the Income Tax (Employments) Regulations 1993, reg 49 and the Social Security Contributions (Transfer of Functions, etc) Act 1999. The appellant appealed to the General Commissioners.

The commissioners concluded that the workers were self employed because the terms of engagement were oral only, there was no formal contract protecting the worker, and the worker was paid on a work done basis.

HMRC appealed.

The High Court ([2007] STC 1684) remitted the case to the General Commissioners for rehearing, saying that they should have considered whether the taxpayer had sufficient control over the workers to make them employees.

The case came before the first-tier tribunal.

The appellant did not attend but two workers gave evidence for HMRC. On their evidence, the tribunal judge said that the appellant regularly exercised control over the workforce, either personally or through other trusted workers of his.

On this basis, the workers were employees of the appellant and the taxpayer's appeal was dismissed.

The judge added that in this case it was significant that the workers were not in business on their own account in the sense of taking risk and of drawing up accounts, and that they worked under the control of the appellant.

They were not paid for time off, holidays or sick leave, but in any event there was virtually no flexibility to take time off.

Working hours were fixed by the appellant, and they could be moved to different projects as determined by the appellant.

© Reed Elsevier (UK) Limited

This full decision went into many different factors but in the end concluded in HMRCs favour due to the level of control. Going forward the detail need not be considered – or indeed the level of control. If you meet one of the tests you are self employed!

Another recent case was *Castle Construction (Chesterfield) Ltd v R&C Commissioners SpC 723.*

In the course of its trade providing building services to main contractors on construction sites, the appellant hired 321 workers—consisting of 217 bricklayers, 12 scaffolders, 75 labourers for both bricklayers and scaffolders, 6 foremen/foremen bricklayers, 2 labourer supervisors, 6 fork–lift drivers, 1 driver and 2 slinger signalmen (who direct crane operators either by signal or by radio)—and classed them all as self–employed sub–contractors.

In common with many other building companies the appellant hired all its workers on a sub–contract basis thereby giving it the total flexibility to hire and terminate workers in accordance with its ever–fluctuating workload.

The appellant paid its workers strictly on the basis of an hourly wage for work actually undertaken, calculated in half–hour increments, with no holiday pay, sick pay, or pay when the weather or any other factor rendered work impossible, and the level of pay reflected those various disadvantages.

Most of the workers signed a contract which stipulated, inter alia, that they were a sub–contractor, specified the hourly rate as including a percentage for holiday pay and in respect of which nothing else was due, imposed an obligation on workers to give a week's notice of any holiday, outlined the tax position for self–employed workers, and included a substitute worker clause.

In addition, all of the workers provided certificates under the Construction Industry Scheme (“CIS”) and the appellant accordingly deducted 18 or 20% income tax.

The bricklayers supplied their own tools, save for two tools which were provided onsite.

The bricklayers were all highly skilled tradesmen and were given no instructions on how to exercise their craft; the only control, exercised by the main contractor on site, was where and in what sequence the walls were built.

However, any mistakes made by the bricklayers had to be rectified in their own, unpaid, time.

The appellant carried insurance in respect of injuries and damage inflicted by both employees and sub–contractors.

<u>Status?</u>

In 1999 and 2000 HMRC considered the status of the appellant's workers and concluded that they were rightly being treated as self–employed.

However, following a fresh review in 2005, HMRC indicated that the workers' status was “one of employment” and in July 2007 they issued assessments that the 321 workers were “employed earners” and liable to pay Class 1 national insurance contributions (“NICs”). HMRC also issued determinations under the Income Tax (Pay As You Earn) Regulations 2003, SI 2003/2682, reg 80.

The appellant appealed contending that the workers were sub–contractors.

<u>Most workers self employed</u>

The Commissioners applied the following six “material pointers” that have been laid out in case law:

- the so-called “mutuality of obligation” requirement,
- the famous and often quoted three tests set out … in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 1 All ER 433 ... [(i) obligation on the worker to personally provide his own work and skill, (ii) the ‘control’ test, and (iii) the other terms of contract generally consistent with its being a contract of service];

- the “substitution” point;
- the authorities that concentrate on the issue of whether the worker is in business on his own account;
- the intentions of the parties; and finally
- the approach based on balancing numerous pointers in each direction and standing back and looking at the overall picture.’

Applying the six material pointers and then standing back and looking at the overall picture, the Special Commissioner found on the facts that the appellants had rightly classed the bricklayers as self–employed.

In relation to the other categories of workers, the Special Commissioner found that the scaffolders were self–employed as their casual terms of engagement were identical to those of the bricklayers and they also conducted “their trade” regardless of the particular business for which they currently worked.

Although the case of the labourers, both for the bricklayers and scaffolders, was more finely balanced, when they worked side–by–side with the bricklayers and scaffolders, and worked on identical terms, their status was the same, ie self–employed.

The foremen/bricklayers and supervisors of scaffolders were effectively the “team leaders” who also performed the role of interpreting and passing on the instructions of the main contractors, and they entirely remained site–workers, engaged on precisely the same terms as the main categories, and so they were also self–employed.

The two slinger/signalmen spent part of their time as labourers and did not operate the plant and were also self–employed.

Fork lift truck and lorry drivers

However, the fork–lift truck drivers and the lorry driver fell into a different category as, notwithstanding their casual terms of engagement, the men were operating expensive plant owned or hired by the appellant and were therefore subject to more control in the use of that equipment than the bricklayers and scaffolders.

Accordingly, the fork–lift truck drivers and the lorry driver ranked as employees. It followed that the appeal would be allowed in part.

Appeal allowed in part.

This case again highlighted that status is not a clear cut area and many factors need to be brought into consideration – not so going forward!

Consequences of deemed status

Strictly, the new rules proposed in the consultation do not alter a worker’s actual status. The deeming provisions will treat any payments made as if they are employment income, unless one of the three ‘key tests’ is met.

PAYE would have to be operated on such payments, with the appropriate income tax and National Insurance contributions deducted (including employers’ contributions) and paid over to HMRC.

Presumably workers subject to this new regime will obtain access to the same state benefits regarding a Class 1 National Insurance contribution history as ‘genuine’ employees.

They will not, however, obtain any ‘employment law rights’. Whether benefits such as statutory maternity pay and statutory sick pay are seen as ‘employment law rights’ or benefits will presumably be made clear in due course.

Commencement date

The consultation document states that the ‘Government recognises the effect that the economic downturn has had on the construction industry and intends that the measures developed as a result of this consultation will take effect when the industry is in a stronger position’.

It also notes that it is ‘recognised that getting the timing right for the implementation of the proposed solution is critical’, and that they will ‘take into account representations made on this point’.

This initial consultation exercise by HMRC will close on 12 October 2009.

2. Incorporation and Disincorporation

2.1 Is it worth incorporating?

There are a number of changes taking place to income tax and corporation tax rates:

- From 6 April 2009 the personal allowance for tax increased to £6,475, Classes 1 & 4 National Insurance applies to incomes exceeding £5,715;
- The Small Company Rate for corporation tax increases to 22% from 1 April 2010;
- From 6 April 2010 the personal allowance will be phased out for those earning in excess £100,000 creating a marginal tax rate of 60% for income between £100,000 and £113,000. In addition, a new higher rate of income tax of 50% will be applied to those earning in excess of £150,000.

So, with these changing rates in mind it is time to consider whether incorporating a sole trader into a limited company remains a worthwhile exercise. Indeed, we also need to ask whether we ought to start disincorporating clients that have already transferred their trade into a limited company.

2.1.1 Computational comparisons

The tables below set out the potential tax and NI savings to be made by incorporating a trade. However, the calculations are based on a very simple scenario that assumes that the accounting and tax profits are equal. They are an indication only and it is always advised that any calculations performed for clients are prepared individually and take into account all the relevant facts, including the client's ability to withdraw profit by way of a legally declared dividend (see section 3.4 below).

In the calculations shown in the tables below the following assumptions have been made:

a) Tax and national insurance bands and allowances are increased next year by 2.5%. Rates remain unchanged;

b) A salary equal to the personal allowance (£6,475 for 2009/10 and £6,635 for 2010/11) is withdrawn from the company resulting in a Class 1 NIC liability of which the secondary amount is deductible by the company. However, where profits exceed £113,000 next year it is assumed that no salary will be withdrawn given the phased withdrawal of the personal allowance for incomes exceeding £100,000 from 2010/11 onwards.

2.1.2 2009/10

Profit	Sole Trader	Company	Saving
	£	£	£
£15,000	2,573	1,951	622
£20,000	3,973	3,001	972
£25,000	5,373	4,051	1,322
£30,000	6,773	5,101	1,672
£40,000	9,573	7,201	2,372
£50,000	13,161	9,463	3,698
£75,000	23,411	19,650	3,761
£100,000	33,661	29,838	3,823
£125,000	43,911	40,025	3,886
£150,000	54,161	50,213	3,948
£175,000	64,411	60,400	4,011
£200,000	74,661	70,588	4,073
£250,000	95,161	90,963	4,198

2.1.3 2010/11

The savings reduce at lower profit levels next year due to the increase in the corporation tax rate from 21% to 22%. However, at higher profit levels the savings increase significantly as the effective combined rate of tax & national insurance on self employed income is 51% whereas the higher rate of tax on dividends is 42.5% (translating to 36.11% of the net dividend).

Profit	**Sole Trader**	**Company**	**Saving**
	£	**£**	**£**
£15,000	2,530	2,004	526
£20,000	3,930	3,104	826
£25,000	5,330	4,204	1,126
£30,000	6,730	5,304	1,426
£40,000	9,530	7,504	2,026
£50,000	12,988	9,704	3,284
£75,000	23,238	19,898	3,340
£100,000	33,488	30,273	3,215
£125,000	46,392	43,258	3,134
£150,000	56,642	53,633	3,009
£175,000	69,392	64,174	5,218
£200,000	82,142	76,716	5,426
£250,000	107,642	101,799	5,843

2.2 Advancing income

Whether the traders chooses to remain self employed or incorporate there will be a case for advancing income. With increases in tax on the horizon clients will need to consider whether they want to pay tax earlier at a lower rate or later at a higher rate.

Examples: advancing income
Harry earns £120,000 a year. If he advances £20,000 from 2010/11 into 2009/10, he will avoid the loss of his personal allowance in 2010/11. He will pay £8,000 more for 2009/10 but at least £10,590 less for 2010/11 (£8,000 plus 40% x £6,475). That is a good rate of return, not least because it is tax-free.

Harriet earns £200,000 a year. If she advances £50,000 from 2010/11 into 2009/10, she will avoid the 50% rate in 2010/11. She will pay £20,000 more for 2009/10 but £25,000 less for 2010/11. Again, that is a good rate of return.

There are many standard ways of advancing income to an earlier year, and they are probably all well-known:

- paying dividends from a small company prior to 6 April 2010;
- advancing payments of salary;
- deferring expenditure which is allowed on a paid basis, e.g. staff bonuses;
- making sure that stocks and WIP are fully accounted for at the last year-end before the 2010/11 basis period;
- paying distributions from trusts;
- claiming for losses in a later year rather than an earlier year;

- closing a bank account early to trigger the receipt of accrued interest.

One particular area in which the timing of income should be considered is illustrated by the following example.

Example – accounting date
George is an architect who has been trading for many years with an accounting date of 30 April. His business has grown substantially in recent years; his overlap relief brought forward is only £16,000, but he estimates that his profits are likely to be:

Year to 30 April 2008	£120,000
Year to 30 April 2009	£150,000
Year to 30 April 2010	£180,000
Period to 31 March 2011	£150,000

He intends to retire on 31 March 2011.

George's problem is that the 30 April year-end means that the increases in his income are deferred into later years when the tax rates will be higher. If he does nothing, he will be taxed on the following profits:

2008/09	£120,000
2009/10	£150,000
2010/11 (£180,000 plus £150,000 less £16,000)	£314,000

£164,000 of profit will be taxed at 50%.

If we assume that profits accrue evenly in the accounting periods, consider the effect of changing the accounting date to 31 March 2009:

Year to 30 April 2008	£120,000
Year to 30 April 2009	£150,000
Period to 31 March 2010	£165,000
Year to 31 March 2011	£165,000

The tax charges change as follows:

2008/09	£120,000
2009/10 (£150,000 + £165,000 – £16,000)	£299,000
2010/11	£165,000

Only £15,000 of profit will be taxed at 50%. There is a significant advancing of tax liability, but the cash flow comparison is still likely to be favourable:

	If the change is made	
2009/10	**£149,000 more taxed at 41%**	**+ £61,090**
2010/11	**£149,000 less taxed at 51%**	**– £75,990**

That is a very good rate of return.

Of course, someone with a 30 April year end and overlap relief which is very small in comparison to the current level of profits was always going to suffer badly on cessation; but the problem is exacerbated considerably by the increase in tax rates.

It should also be noted that an incorporation will trigger the cessation provisions for income tax purposes and will invariably crystallise higher taxable income figures in the final year – assuming overlap brought forward is small in comparison to current profit levels. Incorporating in 2009/10 will only trigger a maximum of 40% tax whereas in later years it could well be 50%.

2.3 Corporate and an LLP?

For clients wishing to minimise their tax bill on their annual profits the corporate remains the favoured vehicle – even in the new tax regime.

There may however be occasions where an LLP can run alongside the corporate if the client feels there are good prospects of significant gains. By holding the key asset in the LLP and licensing it to the company to exploit we would have the best of both worlds – this is commonly seen where the asset is intellectual property (IP).

The corporate would generate the trading income from the licensed IP and the client would have access to the lower corporate rates and more efficient personal taxes via dividends etc. When the IP is eventually sold the client will have the benefit of a personal capital gain (via the LLP) and have access to the 10% rate via Entrepreneurs Relief and then the 18% rate on gains exceeding the Entrepreneurs Relief limits.

If the client was able to sell the shares in the company then this structure would not be needed but most buyers will prefer to purchase trade and assets rather than shares. The LLP/Corporate structure gives the client a better chance of securing the lower CGT rates on asset disposal ie they are not reliant on a compliant purchaser to secure the CGT rates on sale.

2.4 The latest on ESC C16

ESC C16 has always been popular but with increasing income tax rates it is likely to become even more popular. A CGT rate of 10% is far more attractive that an income tax rate of 50% so entrepreneurs may be keen to ensure that "value" is taken out of the company as capital rather than income.

ESC C16 may however been on the verge of disappearing – or is it?

HMRC recently issued *Extra-statutory concessions: Technical consultation on draft legislation*, seeking views on the legislative effect that is being given to some concessions.

This follows the House of Lords' decision in *R v CIR ex p Wilkinson* [2006] STC 270, which raised issues about the validity of ESCs and the extent of HMRC's discretion to make and apply them under their care and management (now 'collection and management') powers in TMA 1970, s 1(1).

The Wilkinson case concerned HMRC's refusal of a widower's claim to widow's bereavement allowance. The taxpayer argued that s 1(1) gave HMRC a discretionary power to grant concessions, which could include making allowances to widowers.

However, the House of Lords dismissed his appeal. Lord Hoffmann said that HMRC's powers under s 1 should not be construed 'so widely as to enable the commissioners to concede, by extra-statutory concession, an allowance which Parliament could have granted but did not grant'.

<u>Recent developments</u>

Legislation was recently introduced to allow HMRC to continue applying ESCs that might otherwise fall outside their discretionary powers.

Finance Act 2008, s 160 allows the Treasury to give effect to existing HMRC statements, e.g. ESCs, statements of practice, Revenue interpretations, decisions and press releases, including powers to modify existing concessions, and to amend, repeal or revoke any enactment or instrument, whenever made.

The consultation document divides the existing ESCs between:

- those that can be legislated under s 160 (or other powers);

- concessions that can remain as such because they are considered 'intra vires', i.e. within HMRC's discretionary powers and are linked to other ESCs in the s 160 category; and
- those where 'clarification' is needed before legislation is drafted; this includes ESC C16 ('Dissolution of companies under s 652 and s 652A Companies Act 1985; distributions to shareholders').

The story so far…

Extra-statutory concession C16 broadly allows distributions to shareholders on the dissolution of a company to be treated as capital distributions within TCGA 1992, s 122, as opposed to income distributions within TA 1988, s 209, if certain conditions are satisfied and assurances are given to HMRC.

This article deals with the dissolution of private companies. While it is not primarily concerned with those ESC C16 requirements, it is worth mentioning a few practical issues regarding the concession.

The first practical issue is that two additional conditions are listed in HMRC's *Company Taxation Manual* (at CTM36220), which are not listed in ESC C16. HMRC's manuals do not carry the force of law, but they are generally a useful guide of HMRC practice and are perhaps worthy of particular note in the context of concessions.

The first additional condition is that the company is not the subject of an investigation. The second additional condition is broadly that the company is not potentially 'caught' by the transactions in securities anti-avoidance provisions of ITA 2007, s 684 (formerly TA 1988, s 703) in respect of the following (listed under sub-paragraphs (e) or (f) of CTM36875, but paraphrased below):

- transfers or sales of the company's assets or business to another company with some or all of the same shareholders followed by the liquidation of the former company or the sale of shares in either company;
- capital receipts by the company's (or group's) shareholders following a demerger or reconstruction from the sale or liquidation of one demerged company where the same shareholders retain an interest via another company involved in the transactions.

HMRC officers should not automatically refuse to apply ESC C16 if the company and its shareholders fail to meet all the relevant conditions. They should instead refer the matter to their technical specialist colleagues for further consideration.

A further practical issue is what happens if the company has already made distributions as part of the dissolution process, without having sought HMRC's prior approval to apply ESC C16.

Thankfully HMRC's own guidance allows ESC C16 to have retrospective effect.

ESC C16 in practice

The concession is intended to benefit companies and their owners by saving the costs associated with a formal winding up.

In addition, potentially lower rates of capital gains tax in recent years; business asset taper relief, where it was available prior to 6 April 2008 and the single 18% rate in the current tax year reduced by entrepreneurs' relief, if applicable, means that capital distributions are very often more attractive to the company's shareholders than those liable to income tax.

Distributions made in respect of share capital in a winding up are specifically excluded from being 'distributions' in tax terms (TA 1988, s 209(1)).

However, the distribution of assets by a company followed by its dissolution under Companies Act 1985, ss 652 or 652A does not amount to a winding up for the purposes of TA 1988, s 209(1).

HMRC generally consider that a company is wound up either by a court order or voluntarily by company resolution in accordance with the Insolvency Act 1986, Part IV (CTM36105).

Extra-statutory concession C16 therefore is based on the fiction that the company has been formally wound up for the purposes of determining the tax treatment of distributions during the dissolution process.

Companies Act 1985, s 652 ('Registrar may strike defunct company off register') and s 652A ('Registrar may strike private company off register on application') are being replaced by largely equivalent provisions in Companies Act 2006, Part 31, chapter 1 ('Striking off') and secondary legislation with effect from 1 October 2009.

Both sets of provisions deal with company dissolutions. They are not concerned as such with the distributions of assets on a winding up. As HMRC put it:

'Dissolution under s 652 is not considered to amount to a winding-up under the Insolvency Act. You should not refer to it as a winding-up, nor as an "informal liquidation"' (CTM36205). However, the ESC C16 process is still commonly referred to as an 'informal winding up'.

<u>Problems with ESC C16</u>

Notwithstanding HMRC's comments above, in practical terms the ESC C16 process typically involves the distribution of a company's assets, including the repayment of its share capital represented by those assets.

For company law purposes, a distribution does not include the repayment of paid-up share capital, or a distribution of company assets to its members on its winding up (CA 2006, s 829(2)).

A problem with ESC C16, as highlighted in the *Wilkinson* case, is that it is a deeming provision for tax purposes. It has no application for company law purposes. It does not allow assets representing share capital to be distributed, and such an action is therefore unlawful in company law terms where the concession is applied.

A further problem with ESC C16 is that in the absence of a winding up (or certain other procedures, such as making the company unlimited to enable it to reduce its share capital), the company's share capital, and any other property and rights still held not repaid or transferred prior to dissolution are strictly 'bona vacantia' and become assets of the Crown, Duchy of Lancaster or the Duke of Cornwall.

However, in practice the Bona Vacantia division of the Treasury Solicitor's department will allow up to £4,000 to be repaid without seeking recovery as an unauthorised distribution.

<u>Reducing share capital</u>

What if the company's share capital exceeds £4,000? Previously, reducing share capital was (and still remains) possible with the court's approval. Alternatively, as mentioned, some private companies re-registered as unlimited for the same reason.

However, since 1 October 2008, private limited companies have been able to reduce their share capital, using a solvency statement procedure introduced in Companies Act 2006 (ss 642 to 644) and supporting Regulations (The Companies (Reduction of Share Capital) Order, SI 2008 No 1915).

A private company can reduce its share capital by special resolution, supported by a solvency statement, a memorandum of capital (or a statement of capital as defined in Companies Act 2006, s 644, with effect from 1 October 2009) and a statement of compliance by the directors.

The Companies (Reduction of Share Capital) Order 2008 prescribes the form in which such solvency statements must be made. Companies House has not yet produced standard documents for the new capital reduction procedure, and companies (or their advisers) must therefore produce suitable documents themselves.

The company can reduce its capital in any way it chooses, including repaying share capital in excess of the company's 'wants'. However, there are certain conditions attached to the capital reduction procedure.

For example, there must be at least one member holding a non-redeemable share following the reduction (s 641(2)). The procedure is also subject to anything in the company's memorandum or articles preventing a reduction of the company's share capital.

The company's directors must make a solvency statement up to 15 days before the passing of the special resolution. A copy of the solvency statement and resolution, and the memorandum concerning the company's share capital and directors' compliance statement, must be delivered to Companies House within 15 days of the resolution to reduce the company's share capital being passed. The capital reduction will not take effect until Companies House registers the relevant documents.

The written solvency statement (within s 643) must be signed by each of the directors, stating that, in their opinion:

- at the statement date there are no grounds on which the company may be unable to pay its debts; and
- if a winding-up of the company is to commence within 12 months of the solvency statement, the company will be able to fully meet its debts within that period; or
- in any other case the company will be able to meet debts as they fall due during the year immediately following the solvency statement date.

The special resolution must also make any necessary alterations of the company's memorandum by reducing its share capital and shares (s 641(1A)). There is no need for a supporting auditors' report (in contrast to, for example, redemptions or purchases by private companies out of capital).

However, the directors must have reasonable grounds for the opinions expressed in a solvency statement delivered to Companies House, or otherwise a criminal offence is committed by each of them.

The company and its officers are also liable to a fine if the company files a solvency statement with Companies House that was not provided to the shareholders in accordance with the legislation.

This whole process should therefore not be taken lightly.

The Act says that reserves resulting from a reduction of capital are not distributable (s 654(1)). However, this is subject to any Order to the contrary.

The Companies (Reduction of Share Capital) Order 2008 provides that reserves arising from the solvency statement procedure are treated as distributable subject to certain exceptions, and are treated as 'realised profits' falling within the Companies Act 2006 provisions regarding distributions (Part 23).

Capital reductions and C16

While repaid share capital can potentially be treated as a capital distribution for tax purposes, the capital reduction provisions do not seemingly affect the position regarding a company's accumulated realised profits.

Their distribution remains subject to income tax in the hands of individual shareholders, subject to a formal winding up, or to the application of ESC C16.

Nevertheless, the solvency statement procedure followed by an application for ESC C16 treatment may be useful where, for example, the company's share capital exceeds the £4,000 limit for bona vacantia purposes.

In appropriate circumstances, it may be possible to reduce share capital to within the Treasury Solicitor's tolerance limit. The remaining share capital could then be repaid as part of the ESC C16 process.

A 'capital distribution' for capital gains purposes includes a distribution in money or money's worth during the course of dissolving or winding up a company, unless the distribution constitutes income in the shareholder's hands (TCGA 1992, s 122(1), (5)).

Capital distributions by companies to shareholders during a winding up, whether under ESC C16 or in a formal liquidation, are not normally treated as income payments, but as full or part disposals for the purposes of capital gains tax or corporation tax on chargeable gains.

Reductions in share capital under the new solvency statement procedure also generally fall to be treated as capital distributions to the shareholder.

Legislating for C16

HMRC's technical consultation included ECS C16 in a category of concessions for which clarification is needed before legislation is drafted.

The department is understood to be preparing an external briefing paper explaining where clarification is required. The briefing paper was due to be released shortly after the time of writing this article.

It would be interesting to see if HMRC address the conflict between ESC C16 and company law in connection with distributions representing share capital made otherwise than in a formal winding up of the company.

However, it seems more likely that the concession will simply be added to the tax legislation in some form, and perhaps that the exclusion from the meaning of 'distribution' in TA 1988, s 209(1) will be extended to include distributions in the course of the voluntary striking off of a company.

What will happen to the assurances which are presently required to be given to HMRC as part of the ESC C16 application, and how legislative effect will be given to that process, remains to be seen.

Conclusion

The solvency statement route for capital reduction in private companies was introduced to provide a simpler and cheaper means for such companies to reduce their share capital than applying to the court under the Companies Act 1985 procedures, which continue to apply for public companies until 1 October 2009 when they are replaced by substantially the same procedures in Companies Act 2006.

The solvency statement procedure was not introduced with a particular view to dissolving companies and distributing realised profits, whether under ESC C16 or otherwise. However, it could be helpful, as explained above.

Giving legislative effect to concessions would seem to be a change for the better. However, it is perhaps premature to start celebrating the prospect of ESC C16 becoming law until we know the form it will take.

Mark McLaughlin CTA (Fellow), ATT, TEP writing in Taxation in February 2009

3. Why are corporates better?

3.1 Low salary, high dividend

Ultimately the ability to pursue the low salary, high dividend route ensures that the corporate retains a significant tax advantage over the self employed option. Extracting funds free of national insurance would make the corporate the obvious choice for all but the smallest clients.

The owner/director will pay themselves a salary equal to the personal allowance. Further "drawings" will be taken in the form of dividends.

When pursuing this method of extraction it is essential to get the paperwork right in respect of the dividends. Minutes and dividend vouchers will be required and should be produced on a timely basis.

It should be noted that dividends must be properly declared/paid. In many small companies, there is often some confusion over whether a dividend is interim or final, and when dividends are actually 'paid'. Final dividends are normally treated as paid on the date of the resolution approving the dividend, unless a future payment date is specified. However, in the case of interim dividends, The Company Taxation Manual (at paragraph CT20095) states:

'A dividend is not paid and there is no distribution, unless and until the shareholder receives money or the distribution is otherwise unreservedly put at their disposal, perhaps by being credited to a loan account on which the shareholder has the power to draw.'

HMRC go on to say that if 'as may happen with a small company, such entries are not made until the annual audit, and this takes place after the end of the accounting period in which the directors resolved that an interim dividend be paid, then the 'due and payable' date is in the later rather than the earlier accounting period'.

Consequently HMRC consider that payment of an interim dividend is not made until an entry is made in the company's books. If the payment physically leaves the bank account the payment date is clear. Where however interim dividends are simply credited to a director's loan account the payment date is when entered into the records – which may be when the practitioner prepares the accounts post year end. Not ideal where you are trying to utilise the spouses basic rate band with a March dividend.

In the current climate practitioners will also need to ensure that dividends are lawful i.e. the company has sufficient distributable reserves from which to pay the dividend. Where the company has adequate retained profits this should not be a problem. Where however clients are "drawing" what they make then extra care is needed. Management accounts would be ideal but failing that a review of a makeshift balance sheet (cash + debtors – creditors) would give an indication of profit levels (per the ICAEW). And this review should be documented in the body of the minutes.

The low salary could cause problems if the owner manager has a PHI policy which pays out a percentage of earnings when the policyholder is unable to work through illness or accident. The policy must be reviewed to ensure that it takes accounts of dividend income as well.

Do not forget that an employee, who is a worker under the terms of the National Minimum Wage Act, must be paid at least NMWA rates, so a salary equal to the personal allowance would not be possible wherever there is a full time employment contract. The director who is only an office holder under the Companies Act is not a worker under NMWA and this requirement is negated.

3.2 Planning post FA 2009?

FA 2009 imposes a new super tax rate of 50% from 6 April 2010 where an individual's taxable income exceeds £150,000.

For those owner-managers who earn substantial salaries/bonuses, this tax hike will mean that the combined marginal tax/NIC costs for employment income (above £150,000) would be 51% for the individual and 12.8% for the employing company.

From 6 April 2010, dividends also become subject to their own super tax rate of 42.5%. This corresponds to an effective rate of 36.11% of the cash dividend received, which will apply to dividend income falling within the '£150,000 plus' taxable income.

Where substantial dividends are being paid (falling within the £150,000 plus income band), this represents an increase of nearly 45% on the pre-6 April 2010 effective dividend tax rate of 25%.

Dividend income below the £150,000 super tax threshold will remain subject to the effective rate of 25%.

Going forward, owner-managers should therefore exercise more care with the timing of their dividend payments to lessen the impact of the new top effective rate of 36.11%.

The higher rate of tax on the dividend is computed as follows:

	£
Net dividend	900
Tax credit	100
Gross dividend	1,000
Higher rate tax at 42.5%	425
Tax credit	-100
	325
£325 / £900 =	36.11%

Pre-6 April 2010 dividend planning

Many owner-managers are likely to accelerate the payment of planned future dividend payments before the super dividend tax rate takes effect.

Some may feel that their company's cash-flow may not be able to support large dividend payments, but this should not be the case. The owner-manager can pay the dividend (before April 2010) – remembering that the 'tax point' for interim dividends is the date they are paid (see *Potel v IRC* [1970] 46 TC 658). All or most of the dividend monies can then be lent back to the company by crediting the shareholder's loan account. The 25% effective income tax liability on the dividend would need to be found by 31 January 2011.

Where clients are aiming to take advantage of the current 25% rate it will be important to ensure that everything is done to ensure that the required dividend is legally valid and paid before 6 April 2010.

It would be prudent to advise an exchange of cheques or same day transfers (for the dividend and the loan-back) to 'stamp' the timing of the dividend payment beyond doubt.

Income splitting

Following HMRC's defeat in *Jones v Garnett* 2007 STC 1536 (often referred to as the *Arctic Systems* case), a large number of owner-managed companies continue to take advantage of providing tax efficient dividend payments to the owner-manager's spouse.

HMRC's attempts to introduce anti-avoidance legislation were quickly derailed in the face of a massive 'thumbs-down' by the professional bodies and industry groups. The draft legislation was shown to be completely unworkable and it was difficult to see how it would be policed by HMRC and how they would collect the anticipated tax revenues.

Mr Darling seems to have shifted 'income splitting' onto the back-burner – at least for the time being – following statements issued in both the pre-Budget report 2008 and the Budget 2009. Income splitting (provided it is implemented correctly) is therefore very much alive and kicking.

Hitherto, the splitting of dividends between married couples has largely been designed to make full use of the spouse's 10% basic rate band for dividends. After 6 April 2010, it may be given a further twist as owner-managers seek to mitigate the effect of the 36.11% effective rate for dividends.

Loans to shareholders

Under the post-6 April 2010 regime, some might consider making use of loans rather than dividends. Based on current understanding, there are no plans to increase the rate of the TA 1988, s 419 tax – which is 25% of the amount of the loan/overdrawn current account.

Even when the income tax (and NIC) under the beneficial loan rules (ITEPA 2003, s 175) is added on, loans to owner-managers may still prove to be a more attractive option than an outright dividend payment suffering the relevant super tax rate of 36.11%.

It is important to ensure that the loan is properly documented. Although it may seem tempting to draw regular loans/advances, these payments may look like 'PAYE-able' earnings to a vigilant tax inspector.

Summarised from an article by Peter Rayney

3.3 Company car?

The corporate has a distinct advantage over the self employed person in that a company car for spouse or older children is a feasible and beneficial option.

The owner/director will pay tax on all the cars as they are part of his or her remuneration package. Where the cars driven have very low CO_2 emissions the advantages can be significant.

For example, let us assume the company spends £16,000 on a VW Golf 1.6 TDI 105 Bluemotion SE (107 g/km) for the director's wife. Assuming the wife does not work in the business, the benefit of £2,080 (£16k x 13%) would be taxed on the husband. Tax would amount to approximately £832 for a high rate taxpayer and Class 1A would be approximately £266. The company would get a 100% FYA on the purchase, tax relief on all running costs and also be able to claim all the VAT back on the cars running costs. Overall this should be cheaper than providing a car for his wife out of taxed income.

If the company decided to lease the vehicle rather than buy it, the company would recover 50% of the VAT on the car lease and then receive a corporation tax deduction for the full rental cost (including the 50% irrecoverable VAT). The lease rental charges are likely to be around £200 per month so this may well be the preferred option.

This scenario would not really work in an unincorporated business as the private use adjustments would reduce the tax relief to zero!

3.4 Settlement provisions and dividend waivers

The decision in *Buck v HMRC (2008)* examined the question of whether a dividend waiver can constitute a settlement for income tax purposes under what is now Ss624 – 625 ITTOIA 2005.

Mr Buck owned 9,999 shares in a family trading company and the remaining share was held by his wife. Shortly before the company's year ended 31 March 1999, Mr Buck waived his dividend entitlement by formal notice in writing and a dividend of £35,000 per share for that year was then paid out, all of which went to Mrs Buck. They did the same for the following year.

HMRC argued that the two dividend waivers in 1999 and 2000 and the subsequent payments to Mrs Buck represented an arrangement for the purposes of S620 ITTOIA 2005 so that the anti-avoidance settlement legislation applied. They considered that the let-out in S626 ITTOIA 2005 was not in point, given that the arrangement did not represent an outright gift of income-producing property from one spouse to the other and, in any event, the subject-matter of the gift was wholly a right to income. The taxpayer (who was unrepresented and did not attend the hearing) claimed that there was no arrangement – it was in the company's interest to pay out the maximum dividends available and he had not wanted to receive them.

Unsurprisingly, the Special Commissioners found HMRC's arguments convincing, with the result that the waived dividends were treated as Mr Buck's income and so were taxable on him.

It has always been thought that a dividend waiver can be a settlement, provided, of course, that the necessary element of bounty is present. This is certainly the case where the waiver enables another shareholder to receive an increased dividend. However, with dividend waivers, this will not always be the position. A dividend waiver has been described by one commentator as 'the abandonment of a contingent right so that the relevant shareholder does not receive the dividend'. That does not necessarily mean that anyone else receives more. It will do so if a dividend is proposed of a fixed monetary amount and one shareholder waives his entitlement – in that case, the whole of the fixed sum will then go to the remaining shareholders and they will receive more than they otherwise would. That would represent bounty and the settlement provisions could of course apply. However, if a dividend is proposed of a fixed amount per share, the fact that one shareholder waives his entitlement does not increase the amounts payable to the others. In those circumstances, there can be no bounty and no settlement. But it is important not to try to be too clever because, as happened with Mr Buck, if a dividend per share is proposed which is manifestly in excess of the company's distributable profits, the whole arrangement will be a settlement. The amounts payable to the other shareholders will only be possible because the proposed dividend will have been made in the clear knowledge that the waiver would take place.

One cannot take exception to a shareholder receiving a dividend on his or her shares if no-one else receives a corresponding dividend. Where HMRC are likely to become interested is if arrangements are made whereby, say, a 30% shareholder receives more than 30% of the company's distributable profits. In this situation, HMRC will undoubtedly try to invoke the settlement legislation.

The recent provisions on income shifting may have been quietly dropped, but Ss624 – 625 ITTOIA 2005 are still a powerful weapon in the hands of HMRC.

3.5 Loan interest

It is possible to extract profit from a family company by paying interest on the director/shareholders' current and/or loan accounts. In order to satisfy the Finance Act 1996 Loan Relationships rules it is important that the interest rate used reflects a commercial payment by the company. Creating a simple loan agreement or board minute stating that interest on loan or current accounts will be paid by the company at a rate of 2% above base rates often satisfies this test. A higher interest rate may be used provided the risk profile of the company justifies this.

In order to obtain a corporation tax deduction for any interest payments it is important to ensure actual payment is made within twelve months of the end of the accounting period. Accrued interest payments made after this date will only obtain tax relief in the accounting period of payment.

Creation of a loan account

Following the abolition of Stamp Duty on goodwill transfers from 23 April 2002 it has been tempting in recent incorporations to establish significant loan accounts by assigning a significant value to the goodwill. It is essential that the valuation of the goodwill can be justified using the normal principles of third party, full information price.

4. Topical issues

4.1 Extended loss carry back

Finance Act 2009, Section 23 introduces Schedule 6 which makes changes to loss reliefs to permit a temporary three year carry back of trading losses.

An overview of the new relief for businesses

This new relief intended to help businesses during the current recession was announced at the Pre-Budget Report in November 2008, to commence with immediate effect. The relief announced at the time permitted a three year carry back of losses incurred in 2008/09 for unincorporated businesses and for companies the same carry-back effect for losses incurred in accounting periods ending between 24 November 2008 and 23 November 2009. In the Budget 2009 it was announced that the relief would be extended for an additional year, so that businesses would be more likely to benefit from the relief.

Therefore, in summary, the Finance Act 2009 allows trading losses to be carried back against previous profits. The extension will apply to trading losses made by companies in accounting periods ending between 24 November 2008 and 23 November 2010, and trading losses made in tax years 2008/2009 and 2009/2010 by unincorporated businesses.

The amount of trading losses which can be carried back to the preceding year remains unlimited. After carry back to the preceding year, a maximum of £50,000 of unused losses will be available for carry back to the earlier two years. The £50,000 limit or cap applies separately to the unused losses of each 12 month period within the duration of the extension. Therefore, businesses could potentially carry back an extra £100,000 of losses in addition to the unlimited carry back to the preceding year.

The provisions for losses incurred during the first four tax years, or during the final year in which a trade, profession or vocation is carried on, or for trading losses incurred in the final accounting period of a company remains broadly but not totally unchanged.

There are some key differences in the way the relief works for income and corporation tax, so they are now described separately in some detail.

Income tax trading losses

For income tax, the relief is available against the profits of the trade, rather than against total income. This is potentially quite good news for many small businesses, as if the taxpayer has a modest amount of other income this will remain in charge and use up the personal allowances; put another way, the claimant is not forced to use up losses against income which would not be taxable in any event. The legislation is in Sch 6, Finance Act 2009, and references are to paragraphs within the Schedule.

Conditions for relief

Paragraph 1 sets out the basic conditions for relief, which is made by a specific claim. The loss must first qualify for relief under s 64, Income Tax Act 2007 (ITA 2007), which means that the various conditions for general loss relief are imported, such as the trade being carried on on a commercial basis with a reasonable expectation of profit (ss 66 and 68, ITA 2007).

There must then be at least one claim for relief under s 64 for either the year of the loss or the preceding year, or alternatively there is no income in either year against which a claim under s 64 could be made. Relief given under s 64 must be deducted from the loss which is then claimed for relief, under a single claim affecting either two or three years (depending on whether a claim has been made under s 64 in the year preceding the loss).

Method of relief

When relief is given under para 1 the deductible amount, that is the remaining loss not claimed under s 64, is deducted from the trading profits of each of the preceding years working from most recent years first and moving back as the profits of each year are exhausted. Clearly if a claim under s 64 has been made for the year preceding the loss, the claim under para 1 will allow relief in the two preceding years, taking the later year first. If, however, no s 64 claim has been made in the preceding year then relief under para 1 will be given against trading profits of the three preceding years, taking the latest year first.

Restriction of additional relief

The relief is restricted to keep the cost to the Exchequer manageable. The amount set against the preceding year is not restricted, irrespective of whether the claim is made under s 64 against total income, or para 1 against trading profits only. Clearly, if the profits of the preceding year are substantial then additional relief under para 1 may not be needed. When the profits (or total income depending on the claim) of the preceding year are exhausted, carry back then proceeds to the earlier years. The restriction then comes into play, with a maximum of £50,000 of the loss available to carry back by more than one year.

Practical considerations

Because of the interplay between the new relief and other possible loss reliefs, there can be quite a complex decision to make regarding which relief will make the most appropriate claim. The opportunity to restrict the loss claim to trading profits only in the year preceding the loss will be very attractive to taxpayers with modest additional income in those years, such as a client with a buy to let yielding around £5,000 per annum. Allowing this income to remain in charge to tax and be covered by any available personal allowances can present the opportunity to carry additional amounts back to the earlier years and optimise relief, provided the £50,000 cap does not prevent it.

Advisers will also need to consider carefully the status of capital allowance claims which as well as increasing a loss (or reducing it by limiting the claim) may therefore also permit the loss to be tailored to the income available thus achieving in effect a partial offset of the loss – the remainder being carried forward – albeit in the capital allowances pool.

These issues are best illustrated with some practical examples.

Example 1

Adam has sold his buy to let property in October 2007 producing a capital gain of £11,000. Adam has net rental income of £6,000 in each of the tax years 2005/06 to 2007/08, and trading profits of £30,000 in each year. His business incurs a loss of £70,000 (including capital allowances) in 2008/09, and he has interest income in that year of £300. At present he expects to incur further modest losses in 2009/10.

Adam's options are :

- to claim relief in both 2008/09 and 2007/08 under s 64, and then make a claim under para 1; or
- to claim relief under s 64 in 2008/09 and then claim under para 1.

He is unlikely to make a claim to extend his loss relief in 2008/09 to be set against the capital gains arising in that year, as the gain is almost entirely covered by his annual exempt amount, and thus almost no benefit would be gained. This would also prevent any further amount of loss being claimed under para 1, as the full loss after relief under s 64 is converted to a capital loss.

Claim under s 64 for both years

2008/09	**£**	**Loss Memo**
Trading loss		70,000
Interest	300	
S 64 claim	(300)	(300)
Net income	Nil	
2007/08		
Trading profit	30,000	
Rent	6,000	
	36,000	
S 64 claim	(36,000)	(36,000)
Net income	Nil	
2006/07		
Trading profit	30,000	
Para 1 claim	(30,000)	(30,000)
Rent	6,000	
	6,000	
Personal allowance	(5,035)	
Net income	965	
2005/06		
Trading profit	30,000	
Para 1 claim	(3,700)	(3,700)
Rent	6,000	Nil
	32,300	
Personal allowance	(4,895)	
Net income	27,405	

Value received for loss	**Loss**	**Value**
2008/09		
Covered by personal allowance	300	Nil
2007/08		
Covered by personal allowance	5,225	Nil
At starting rate of 10%	2,230	223
At basic rate of 22%	28,545	6,280
2006/07		
At starting rate of 10%	1,185	118
At basic rate of 22%	28,815	6,339
2005/06		
At basic rate of 22%	3,700	814
	70,000	**13,774**

This is an effective rate of relief of 19.7%.

Claim under s 64 for 2008/09 only

2008/09	**£**	**Loss Memo**
Trading loss		70,000
Interest	300	
S 64 claim	(300)	(300)
Net income	Nil	
2007/08		
Trading profit	30,000	
Para 1 claim	(30,000)	(30,000)
Rent	6,000	
	6,000	
Personal allowance	(5,225)	
Net income	775	
2006/07		
Trading profit	30,000	
Para 1 claim	(30,000)	(30,000)
Rent	6,000	
	6,000	
Personal allowance	(5,035)	
Net income	965	
2005/06		
Trading profit	30,000	
Para 1 claim	(9,700)	(9,700)
Rent	6,000	Nil
	26,300	
Personal allowance	(4,895)	
Net income	21,405	

Value received for loss	**Loss**	**Value**
2008/09		
Covered by personal allowance	300	Nil
2007/08		
At starting rate of 10%	1,455	145
At basic rate of 22%	28,545	6,280
2006/07		
At starting rate of 10%	1,185	118
At basic rate of 22%	28,815	6,339
2005/06		
At basic rate of 22%	9,700	2,134
	70,000	**15,016**

The value of the relief has increased by £1,242, and the overall rate of relief is now 21.5%.

Where the taxpayer has a patchy history of higher rate liabilities, this will make a claim under para 1 very tricky, as it is a single claim to relief affecting all of the available years, and thus may involve taking relief at basic rate in order to benefit from some higher rate relief. If the taxpayer expects future profits to be substantial, then it may not be beneficial to claim under para 1, and to limit the claim to s 64 relief if there is a higher rate liability in the preceding year, allowing the balance of the loss to be carried forward to obtain the benefit of relief at higher rates of tax.

Example 2

Betty has incurred a loss for 2008/09. She has no income other than from trading in any year, but indicates that she expects to be a higher rate taxpayer in 2009/10 as a result of winning a new contract. Her profits are likely to be of the order of £100,000 per annum in the future. In 2008/09 she has incurred a loss of £100,000, which includes a capital allowances (AIA only) claim of £35,000. Her profits in 2007/08 were £25,000, and in 2006/07 were £45,000. In 2005/06 her profits were £20,000.

Options available to Betty

- to make claim(s) under s 64 followed by para 1 claim; or
- to make no current claims and carry forward losses to 2009/10; and
- she might consider amending capital allowance claims to alter the position.

Claim under s 64 followed by para 1 claim

2008/09	**£**	**Loss Memo**
Trading loss		100,000
No claim possible – no other income		
2007/08		
Trading profit	25,000	
S 64 claim (mandatory)	(25,000)	(25,000)
Net income	Nil	
2006/07		
Trading profit	45,000	
Para 1 claim	(45,000)	(45,000)
Net income	Nil	
2005/06		
Trading profit	20,000	
Para 1 claim (restricted)	(5,000)	(5,000)
	15,000	25,000
Personal allowance	(4,895)	
Net income	10,105	

Value received for loss	**Loss**	**Value**
2007/08		
Covered by personal allowance	5,225	Nil
At starting rate of 10%	2,230	223
At basic rate of 22%	17,545	3,860
2006/07		
Covered by personal allowance	5,035	Nil
At starting rate of 10%	2,150	215
At basic rate of 22%	31,150	6,853
At higher rate of 40%	6,665	2,666

2005/06			
At basic rate of 22%		5,000	1,100
		75,000	14,917
2009/10			
Anticipated c/f at higher rate of 40%	25,000	10,000	
		100,000	**24,917**

This is an effective rate of relief of 24.9%.

Carry forward the loss – no current claims

2008/09		**£**	**Loss Memo**
Trading loss			100,000
2009/10			
Trading profit		100,000	
Carry forward loss (s 83 ITA 2007)	(100,000)	(100,000)	
Net income		Nil	Nil

Value received for loss	**Value**	**Loss**
2009/10		
Covered by personal allowance	6,475	Nil
At basic rate of 20%	37,400	7,480
At higher rate 40%	56,125	22,450
	100,000	**29,930**

This is £5,013 better than option 1, at a rate of relief of 29.9%.

Amending the 2008/09 capital allowances claim to nil

Claim relief under s 64 and para 1

	£	**Loss Memo**
2008/09		
Trading loss		65,000
No claim possible – no other income		
2007/08		
Trading profit	25,000	
S 64 claim (mandatory)	(25,000)	(25,000)
Net income	Nil	
2006/07		
Trading profit	45,000	
Para 1 claim	(40,000)	(40,000)
Net income	5,000	Nil
Personal allowance	(5,000)	
Taxable income	Nil	

The amount shown as capital allowances will gain tax relief at 40%, being allowed in future years as WDA.

Value received for loss		**Value**	**Loss**
2007/08			
Covered by personal allowance		5,225	Nil
At starting rate of 10%		2,230	223
At basic rate of 22%		17,545	3,860
2006/07			
Covered by personal allowance		35	Nil
At starting rate of 10%		2,150	215
At basic rate of 22%		31,150	6,853
At higher rate of 40%		6,665	2,666
		65,000	13,817
2009/10			
Anticipated c/f at higher rate of 40%	35,000	14,000	
		100,000	**27,817**

This has improved relief over option 1 but is not as attractive as option 2. The rate of relief of 27.8%.

Amending the 2008/09 capital allowances claim to nil

Carry forward the loss – no current claims

2008/09		**£**	**Loss Memo**
Trading loss			65,000
2009/10			
Trading profit		100,000	
Carry forward loss (s 83 ITA 2007)	(65,000)	(65,000)	
Net income		35,000	Nil

Capital allowances once again disclaimed so that they can be claimed in future only against higher rate liabilities.

Value received for loss		**Value**	**Loss**
2009/10			
At basic rate of 20%		8,875	1,775
At higher rate 40%		56,125	22,450
		65,000	24,225
2010/11 & subsequent			
Anticipated c/f at higher rate of 40%	35,000	14,000	
		100,000	38,225

This is the best option of all, providing relief at a rate of 38.2%.

Corporation tax losses

Companies are also permitted to carry trading losses arising in accounting periods ending between 24 November 2008 and 23 November 2010 back against total taxable profits of the three preceding years. The relief is very similar to that provided for income tax, with the legislation commencing at para 3 of Sch 6 to FA 2009.

The relief amends the current 12 month carry back provision in s 393A ICTA 1988 to provide that the time period to which the loss can be carried back is now the three years preceding the loss making period. Relief is given against total profits chargeable to corporation tax, thus extending the relief for companies to other income of all types and chargeable gains.

Losses are set against the most recent periods first, only going back to earlier periods when the profits of the later year have been exhausted, but this is a single claim to relief, affecting all three years – it is not possible to pick and choose which years are included in the claim.

The capping mechanism seen above also applies to corporation tax, with the cap being expressed separately in relation to the time periods as follows :

- for a loss in an accounting period (or periods) ending between 24 November 2008 and 23 November 2009 the limit is £50,000; and
- for a loss in an accounting period (or periods) ending between 24 November 2009 and 23 November 2010 the limit is £50,000.

Once again, the cap restricts only the additional relief introduced by FA 2009, with unrestricted relief given in the preceding year under the existing s 393A ICTA 1988.

For a company with an accounting date early in the window (such as 31 December) it is not possible to enhance relief by changing accounting date and preparing accounts for the 10 months to 31 October 2010 – the £50,000 cap would prevent any additional relief being available. Where an accounting period is less than a year in length the £50,000 is apportioned to the appropriate number of days.

Practical effect

In terms of planning to optimise loss relief, advisers will wish to consider competing claims, and how available profits are best used to relieve losses.. There are no issues in corporation tax of wasted personal allowances, and the impact of varying marginal rates of tax is likely to be minimal in practice, so planning to use the relief in corporation tax is a simple matter when compared to the same task for income tax.

4.2 FA 2009 changes to personal pension contribution relief

From April 2011, pension relief for then higher paid will be restricted so that ultimately they only benefit from basic rate relief on their premiums. The restriction will commence at £150,000 at the point the new 50% rate of income tax bites, but will gradually taper tax relief on the contributions so that at £180,000 of income the relief obtained is 20%. However, the legislation to implement this change has not yet been prepared, and in the meantime Government has been concerned to prevent affected taxpayers from accelerating payments into the regime applying presently to maximise current relief.

Section 72 therefore introduces Schedule 35 which creates the new (temporary) special annual allowance charge which will apply during 2009/10 and 2010/11 until the change described above commences.

Overview

The special annual allowance charge is modelled on the annual allowance change in the existing legislation. The main points are as follows :

- The charge will only apply to those with "relevant income" in the relevant year of more than £150,000, although if income in either of the two preceding years exceeds this limit the individual is within the legislation, in order to prevent them manipulating their income downwards in the two affected years;
- Affected individuals will always be able to contribute £20,000 to a pension in 2009/10 and 2010/11 irrespective of their past history of contributions;
- Affected individuals will be able to continue to make pension contributions equal to the amount they have previously contributed by way of regular contributions under contracts which commenced before 22 April 2009;
- Those who have made annual or other irregular (less often than quarterly) contributions will be limited to either the average of their last 3 years contributions or £30,000, whichever is lower (but subject always to £20,000 minimum);
- Contributions by employers to defined contribution schemes are included in the pension input amount which is tested against the limits;
- Contributions to defined benefit arrangements are not tested, but enhancement of benefit is the measure of "pension input amount" used for the legislation;
- Pension inputs are not liable to both the annual allowance charge and the special annual allowance charge – the annual allowance charge takes precedence, as it is calculated at 40%;
- The tax charge arises on any excess contribution at a rate of 20% in 2009/10; this is likely to increase to 30% in 2010/11, and
- The tax will be collected through the self assessment system.

Example

	£
An individual has the following :	
Income	172,000
Pension contributions – regular (£4,000 per month)	48,000
Extra contributions in 2009/10	25,000
Special annual allowance charge computation	
"Relevant income" is	172,000
Less pension contributions but maximum	(20,000)
	£152,000
Pension input amount	48,000
	25,000
	73,000
Less : protected pension inputs	(48,000)
Adjusted pension input	25,000
Special annual allowance	20,000
Less protected pension inputs	(48,000)
Adjusted special annual allowance	NIL
Special annual allowance charge arises on	
Adjusted pension input – special annual allowance =	25,000
Tax at 20%	£5,000

© Reed Elsevier (UK) Limited

Planning advice

Pay a gift aid donation of £1,650 in 2010/11 and elect to carry back :

Relevant income above	152,000
Less Gift aid (gross amount)	(2,063)
Relevant income	149,937

So the special annual allowance rules do not apply (provided the income does not exceed £150,000 in either of the two preceding years).

Tax saving : Higher rate liability (on gross gift)	413
Tax on special annual allowance charge	5,000
Total tax saved	5,413

Net cost of donation = £1,650 - £5,413 = £(3,763)

5. Relief for Capital Expenditure

References are to CAA 2001 unless otherwise stated.

5.1 The "Annual Investment Allowance" (AIA) S.38A

For accounting periods ended on or after 6 April 2008 (1 April 2008 for companies), a new "annual investment allowance" (AIA) has been introduced. The AIA is intended to "encourage greater levels of investment by reducing the costs of capital".

The new "annual investment allowance" gives a 100% first year allowance for the first £50,000 of investment in "standard" plant & machinery (excluding cars but including integral features – see section 2). The AIA replaces the existing first year allowances available to small and medium businesses.

The AIA is available to all businesses (including ordinary property businesses and large companies), although only one £50,000 annual allowance will be available to each business each year.

A group of companies is treated as one business for the AIA, although "associated" companies will get one AIA each.

Sole trader businesses and partnerships will each receive an AIA. Therefore where an individual is involved in more than one business (for example, he may be a partner in a firm and run a sole trader business in his own right at the same time), both businesses will receive an AIA.

If the accounting period of the businesses is more or less than 12 months long, the AIA is proportionately reduced or increased. Thus for a business drawing up a 9-month set of accounts, the AIA limit will be £50,000 x 9/12 = £37,500.

Expenditure in excess of the AIA limit in the year will be dealt with under the standard rules for capital allowances, qualifying for capital allowances at either 10%, 20% or the "hybrid rates".

Unused expenditure will be lost – there is no provision for the unutilised portion of the £50,000 allowance to be carried forward.

Where the accounting period spans 6 April 2008:

1) pre April 2008 expenditure will qualify for first year allowances under the "old" rules at either 50% or 40%; and

2) post April 2008 expenditure will qualify for CAs under the new AIA rules. The £50,000 threshold will be restricted for the number of months in the accounting period which fall after April 2008.

5.2 New First Year Allowances (FA 2009)

A new, temporary 40% first-year allowance (FYA) applies to expenditure on plant and machinery that would otherwise be allocated to the main pool because it is expenditure in excess of the £50,000 cap for the annual investment allowance. Expenditure on certain assets, including long-life assets, integral features, cars and assets for leasing will be excluded.

The 40% FYA will be available, for expenditure incurred in the period of 12 months from 1 April 2009 for corporation tax and 6 April 2009 for income tax, to any company, partnership or individual carrying on a 'qualifying activity'.

Illustration 1

Darling Limited draws accounts to 30 September each year. In the year ended 30 September 2009, the company incurred the following capital expenditure;

		Cost
		£
1 December 2008	Production equipment	45,000
1 May 2009	Tools & machinery	60,000
1 August 2009	New air conditioning system	15,000

The general pool brought forward at 1 October 2008 was £12,000.

- Total expenditure on plant is £120,000 so the AIA will not cover the full amount;
- The production equipment is not eligible for the new FYA as it was acquired before 1 April 2009;
- The new air conditioning system is an integral feature so does not qualify for the new FYA of 40%. The AIA should be allocated to nthis expenditure first;

The capital allowances computation will therefore be:

Y/e 30.9.09	AIA @ 100%	FYAs @ 40%	General Pool	Total
	£	£	£	£
B/fwd			12,000	
Additions:				
Production equipment	35,000		10,000	
Tools & machinery		60,000		
Air conditioning	15,000			
	50,000	60,000	22,000	
AIA @ 100%	(50,000)			50,000
FYA @ 40%		(24,000)		24,000
WDA @ 20%			(4,400)	4,400
			17,600	
Transfer to pool	NIL	36,000	36,000	
C/fwd at 30.9.10			53,600	
CA claim for year				£78,400

5.3 Integral features S.33A

For capital allowances purposes the boundary between what is a "plant and machinery" and what is a "commercial building" is not absolutely clear.

Instead, case law draws a distinction between equipment "with which" a business is carried on and the premises or setting "in which" the business is carried on. These case law tests were (to a certain extent) consolidated and given statutory authority in Capital Allowances Act 2001.

This has essentially meant that certain assets which are "integral" to a building (such as air conditioning systems and lifts etc) previously qualified for 25% writing down allowances whereas others (such as electrical and water systems) were deemed to be part of the building and did not qualify for CAs.

From 6 April 2008, "integral features" are separately identified in a new "special rate pool" on which writing down allowances will be given at 10%. According to the government, assets such as lifts and air-conditioning systems have a longer economic life than other more "productive equipment" used in the business, so the new special rate pool offers "a more appropriate rate of write-off of these assets".

A separate pool need only be kept for integral features acquired on or after 6 April 2008. Such assets bought before April 2008 will either qualify for FYAs (or, for large enterprises, go into the general pool). Some may not have qualified for any capital allowances at all.

Where such "integral features" are bought second-hand after April 2008, they may have received a 40% or 50% FYA for the initial user - now they will receive a 10% WDA for the new user.

Expenditure on integral features on or after 6 April 2008 will always qualify for writing down allowances at 10% (irrespective of whether this falls into a transitional period).

FA 2008 introduced a list of features which are "integral" to a building and which will therefore only qualify for capital allowances at 10%. These are;

- Lifts, escalators & moving walkways
- Space & water heating systems
- Air-conditioning and air cooling systems
- Hot & cold water systems (excluding toilet & kitchen facilities)
- Electric lighting and power systems
- External solar shading

From April 2008 expenditure on thermal insulation in buildings will also be allocated to the "special rate" pool and will be given allowances at 10%. S.28

5.4 Small plant & machinery pools S.56A

From 6 April 2008, businesses can claim a writing down allowance of up to £1,000 when the tax written down value brought forward in either the general pool or the new "special rate pool" ("10% pool") is £1,000 or less.

This means that businesses who have very small brought forward balances in the general pool will no longer have to calculate WDAs at 20% on such pools – instead where the pool is £1,000 or less, the full amount can be written down. This is intended to lessen the administration burden for small businesses.

Businesses do not have to take the maximum allowance – they may claim less than the whole residue if they prefer.

This rule applies for accounting periods beginning on or after 6 April 2008 (1 April 2008 for companies).

The small pool limit £1,000 is scaled up or down for short or long accounting periods. It does not apply to "single asset" pools.

Illustration 2

Nancy is a full-time mother, but for 2 evenings a week she runs a fitness class at the local community centre. Her only capital assets are some fitness equipment and a computer bought a couple of years ago for £2,400. She draws accounts annually to 30 June. The written down value of the general pool at 1 July 2007 is £900.

Her capital allowances computations are as follows:

The hybrid CA rate to be applied for the year ended 30 June 2008 will be;

9 months at 25%	9/12 x 25%	18.75%
3 months at 20%	3/12 x 20%	5.00%
Hybrid rate in transitional period		23.75%

Year ended 30 June 2008:	Pool	CA claim
	£	
Tax written down value b/fwd at 1.7.07	900	
WDA @ 23.75%	(214)	214
Tax written down value c/fwd at 30.6.08	686	
Year ended 30 June 2009:		
Tax written down value b/fwd at 1.7.08	686	
WDA	(686)	686
Tax written down value c/fwd at 30.6.09	NIL	

5.5 Capital allowances on cars

A car costing over £12,000 has until now been required to be placed in a single asset pool for capital allowances purposes. Writing-down allowances (WDAs) are available at 20% but cannot exceed £3,000 per annum for each such car. These were known as the 'expensive car' rules. The expensive car rules are abolished for expenditure incurred on or after 1 April 2009 for companies and 6 April 2009 for non-corporate businesses.

Instead, all new qualifying expenditure on cars used exclusively for the business will go either into the main 20% pool or into the special rate 10% pool. This will be determined by the level of the car's carbon dioxide emissions. Cars with emissions over 160g/km will go into the special rate pool.

Cars with an element of non-business use will continue not to be pooled but will attract only the 10% special rate of WDAs if their emissions exceed 160g/km. These rules will not apply to motor cycles, which will instead become eligible for the annual investment allowance, first-year allowances and short-life asset treatment. Expenditure incurred before 1 April/6 April 2009 on cars costing over £12,000 will continue to be subject to the previous rules for a transitional period of about 5 years. At the end of the transitional period, any remaining written-down value will be transferred to the main pool.

Where a car worth more than £12,000 is leased rather than purchased, there were rules restricting the amount of lease rentals deductible in computing business profits. These are also abolished, in this case where the lease period begins on or after 1 April/6 April 2009. Instead, only 85% of the expenditure on leasing a car with carbon dioxide emissions above 160g/km will be deductible. Where there is a chain of leases, this restriction will apply only to lease rental payments made by one lessee in the chain. There will be no restriction where the car is made available to the business for a period of no more than 45 consecutive days or if the business sub-hires the car to a customer for a period of more than 45 consecutive days (except where the business makes cars available to its employees or to the employees of a connected person). Lease periods or sub-hire periods may be aggregated in determining whether the period exceeds 45 days. There will be no restriction on the deduction of expenditure on the leasing of a car with lower emissions or of a motor cycle.

These changes will dramatically reduce the timing of any tax relief as the example shows:-

Car – Cost £18,000, Sold £8,500 after 3 years (>160 gms per Km)

Current rules:

	WDAs	**Cum. WDAs**
Year 1	£3,000	£3,000
Year 2	£3,000	£6,000
Year 3	£2,400	£8,400
Year4 (sale)	(Bal.allow)£1,100	£9,500

New rules:

	WDAs	**Cum. WDAs**
Year 1	£1,800	£1,800
Year 2	£1,620	£3,420
Year 3	£606	£4,028
Year 4 (sale)	(No bal. allow)£547	£4,575

Thankfully the self employed retain the right to a balancing adjustment as their cars will invariably have private use and be shown in their own column in the tax computations.

6. Wholly and exclusively

6.1 Wholly and exclusively

Expenses are only deductible if they are incurred **"wholly and exclusively"** for the purposes of the trade.

6.1.1 Private expenditure

When preparing accounts, traders often include items which relate in whole or in part to their own private affairs (ie not to the business). For example a trader may decide to deduct a "salary" which he pays to himself out of the profits of the business. This "salary" is not taxable on him as employment income since his profits are charged to tax as trading income as a self-employed individual (he is not an employee).

Consequently we add back any salary or wages drawn from the business by the proprietor in arriving at the tax adjusted trading profit. Salaries paid to employees are allowable as there is a corresponding charge to income tax on the employment income.

Mortgage interest relating to the traders private residence is clearly a private expense and is not incurred "wholly and exclusively for the purposes of the trade". It should therefore be added back. However, interest paid on a loan to buy business premises (shop, office etc) will be allowed as a trading deduction.

<u>Dixon v HMRC (SpC 511)</u>

In the recent case of I Dixon v HMRC the commissioners considered whether mortgage interest was deductible for business purposes when part of the property is residential.

A trader purchased a newsagent business and a house which adjoined the premises, with the aid of a mortgage. He claimed a deduction for the whole of the mortgage interest. The Revenue issued discovery assessments on the basis that only 50% of the interest was deductible as a trading expense, the remaining 50% being attributable to the house which D occupied as his private residence. The trader appealed.

The commissioner reviewed the evidence in detail and allowed the appeal in part, holding that 'the apportionment should be based on the value of the residential property against the purchase price of the whole package'. On the evidence, the commissioner directed that 35% of the interest should be attributed to the private residence and that the remaining 65% of the interest was deductible.

Motor expenses are another good example of a private expenditure. Assume a trader drives a car, and he agrees with the Revenue that the car is used 70% of the time for business purposes. However, he deducts all of the costs of running the car in his profit and loss account (eg, all fuel, repairs, insurance, road tax etc). If 70% of the costs are incurred for business purposes, 30% of the costs must be disallowed as they relate to private expenditure which has not been incurred wholly and exclusively for the purposes of the trade. 30% of the motor expenses should be added back to the profit.

Provided the taxpayer proposes a percentage which reasonably reflects the private element of the expense, the Inland Revenue will usually accept it.

The private use adjustment can apply to any expenditure. For example, if a taxpayer uses, say, 20% of his house as an office for the purposes of the trade, he will be able to deduct 20% of the mortgage interest in arriving at his taxable profit. If he has deducted the full amount in his accounts, we would need to add back 80%.

Deductibility of motor rally expenses?

Just because expenditure looks like it might be private it is always worth discussing with the client why they are incurring the costs. The Special Commissioners case of McQueen is a good example.

In 1998–1999 the appellant, who owned a minibus business and was also a keen motor rally driver and sailor, decided to use motor rallying to advertise his business through sponsorship of events and TV coverage. After consulting his accountant on the financial and fiscal implications of that idea, he purchased a new rally car which was painted in the same livery and lettering as his buses and was displayed outside his business premises every day. From 1999 onwards the appellant competed successfully in several rally events and the business sponsored local rallies, including exclusively the G Coaches Rally, during which it entertained customers. In 2001 the appellant bought a new rally car, again painted in the business livery, which he exchanged for a new one the following year. In computing his trading profits in the tax years 1998–1999, 1999–2000 and 2001–2002 the appellant claimed capital allowances in respect of the rally cars and marketing expenditure of £11,733, £11,747 and £25,018 respectively for those years. In 2002 the Revenue opened an enquiry into the appellant's tax returns for those years and subsequently issued discovery assessments under TMA 1970, s 29. The appellant appealed contending that (i) the discovery assessments in respect of the 1998–1999 and 1999–2000 tax years were outside the prescribed limitation period which in cases of alleged innocent mistake was 12 months. The issue arose as to whether, pursuant to TMA 1970, s 29(5), the Inland Revenue officer 'could not reasonably have been expected on the basis of information available to him … to be aware of such … excessive claims for relief'. The appellant stated that the references in his capital allowances claim clearly referred to the rally car and he had made sufficient disclosure; and (ii) the advertising costs and the claim for capital allowances were wholly and exclusively laid out or expended for the purposes of the trade as prescribed by TA 1988 s 74 and were properly deductible in computing the business profits for tax purposes. He argued that the expenditure on motor rallying was for the purposes of the trade. The expenditure resulted from a rational, and in retrospect, successful commercial decision. So far as any benefit accrued to him personally by way of the expenditure, that benefit was purely incidental and could not be said to be the purpose of the expenditure. The Revenue argued that the evidence showed that the non-business advantage to the appellant of promoting his own motor rallying interest and career was the, or at least an, object of the expenditure. There was no business plan, no motor rallying records were kept as evidence of the business purpose and the only people who spotted the business liveries on TV were likely to be locals. Looked at overall, the benefit to the business was incidental. On that basis TA 1988, s 74(1)(a), as amended, applied to prohibit the deduction of the expense as 'not being money wholly and exclusively laid out or expended for the purposes of the trade'.

Decision

The Special Commissioner found that the discovery assessments were all made in time. The reference to 'rally car' in the capital allowances computations served as a clue to the reasonably alert Revenue officer but were nowhere near to clearly alerting him to the possibility of an excessive claim. The reference was not enough to draw attention to the fact that the computation of trading income included expenditure on motor rallying; nor did it indicate how a rally car was seen to be a means of marketing the minibus business. 1998–1999 was the first year in which the business had been claiming motor rallying expenses. There should have been something in the return information for that year to record that the training expenses included motor rallying expenditure. In addition, there should have been a more explicit linkage between the reference to the rally car capital allowance figures and the entry in the main part of the return to which it related. For the years 2000 and 2001 the reference to the rally car was even less explicit and made no mention of 'marketing of business'.

The Special Commissioner found on the evidence that the appellant's motor rallying activities from 1999 onwards were for the purposes of his business trade. Although the appellant derived considerable personal satisfaction from the motor rallying activity, he incurred the expenditure and participated in the events for the purposes of promoting the business and getting the names and liveries into the public awareness. In reaching that conclusion the Special Commissioner took the following facts into account: (i) the use of the business livery and lettering on the rally cars; (ii) the sponsorship of events on a wide scale and the exclusive promotion of the G Coaches Rally; (iii) the use of those events to entertain customers and potential users of the business facilities; (iv) the publicity derived from newspaper coverage and TV features including repeats; and (v) the daily display of the cars outside the business premises. The Special Commissioner was satisfied that motor rallying complemented the business and vice versa. He acknowledged in that connection that the appellant did no research, other than discussing the matter with his accountant, and produced no business plan to demonstrate the potential advantages or otherwise of motor rallying. However at the start (1999) the business was relatively small and was run by the appellant himself and those five specific factors were positive evidence in support of the assertion that business promotion was his objective.

Turning to consider whether the motor rallying (i.e. the produce of the disputed expenditure) secured a private benefit to the appellant or whether it was a merely consequential and incidental effect of that expenditure, the Special Commissioner concluded that the appellant was using his skill and enthusiasm for motor rallying as the best means available to him for promoting the business. The securing of the private satisfaction of success on the rally circuit could properly be described as an incidental effect of the payment. The appellant had many interests and his preferred leisure activity was sailing.
Accordingly the Special Commissioner concluded that the disputed expenditure was laid out wholly and exclusively for the purposes of the trade. It was not therefore excluded from deduction in computing the profits of the trade by TA 1988, s 74(1)(a). The appeals would be allowed.
Appeals allowed in principle.

SpC 601 McQueen v Revenue and Customs Commissioners

6.1.2 Travel expenses

There has been a large number of cases going before the Courts with regard to the "wholly and exclusively" test for travel expenses.

In the case of *Newsom v Robertson,* a self employed barrister claimed the costs of travel from his home in Surrey to his Chambers in Central London. The barrister argued that he worked in both locations – from time to time he needed to prepare cases and read through client files at home. However, he was not listed in the telephone directory as a barrister at his home address, and he did not want his clients visiting him at his home. He could have carried out his paperwork in Chambers, it was just that he chose to work from home. As a result, the Courts were not satisfied that the travel expenses had been incurred wholly and exclusively for the purposes of his profession and therefore disallowed the costs.

In *Horton v Young,* a bricklayer worked at a number of different sites. He negotiated his contracts and kept his records at his home. In order to lay bricks he obviously had to travel to the site at which the bricks needed laying. Therefore the Courts were satisfied that any travel costs were incurred wholly and exclusively for the purposes of the trade. The builder's fixed place of business was his home, therefore travel costs to the site were allowed.

In *Sargeant v Barnes,* a dentist travelled from his home every morning to his surgery. Costs of travelling from home to work are not allowed as a deductible expense for self-employed individuals as they are not incurred for the purposes of the trade. However, the dentist would stop off at the lab on his way to work to pick up bits and pieces of equipment he required to insert into his patients' mouths. He then drove on to the surgery.

The dentist argued that the costs of travel between the lab and the surgery were allowed, effectively saying that his work started on reaching the lab. However the Courts were not satisfied that the costs were deductible as the dentist would have passed the lab in any event as it was on his normal route into to work. Therefore as he did not incur any extra travel costs, the expenses were not deductible.

6.1.3 Subsistence

Generally food consumed by a trader does not meet the 'wholly and exclusively' condition as it is at least partly for the benefit of the individual. As the *Business Income Manual* puts it at BIM 37660:

'The cost of food or drink consumed for the human requirement of sustenance is not allowable. It does not matter that work occasions a greater appetite or causes greater expense. The expenditure is at best dual purpose. There is no mechanism to allow an apportionment to give a "business" proportion or the "extra cost" imposed by the business. The whole cost is disallowed.'

The principle has been tested repeatedly in the courts. So, for example, a self-employed carpenter who spent 40p on lunch while away from home but only 10p while at home was disallowed the 30p difference as a deduction because of duality of purpose. And a firm of solicitors failed to obtain a deduction for the cost of food and drink at various partnership meetings.

HMRC practice

In practice, HMRC have accepted that evening meals and drinks taken in conjunction with overnight accommodation are allowable, if the cost of the accommodation itself is deductible for tax purposes.

HMRC have also acknowledged (BIM 37670) that 'extra costs may be incurred wholly for business purposes where a business is by its nature itinerant (for example, in the case of commercial travellers), or where occasional business journeys outside the normal pattern are made. You may allow a deduction for reasonable expenses incurred in these circumstances'.

It seems fairly clear – given the case law precedents – that this treatment was only ever by concession, but legislation has now been introduced (ITTOIA 2005, s. 57A, effective since 6 April 2009) to give a statutory deduction for certain expenses incurred by the self-employed on food and drink. According to HMRC's guidance note, the legislation 'permits a deduction from the profits of a trade in respect of modest subsistence costs associated with travel, provided the travel expenses are incurred, or would otherwise have been allowable if so incurred, wholly and exclusively for the purposes of the trade'.

The legislation does not use the term 'modest', opting rather for 'any reasonable expenses', and it is unlikely that HMRC will interpret the concept too strictly, within reasonable bounds. The costs may be incurred either at the destination or *en route*. Relief will be due where 'the trade is by its nature itinerant' or where the trader only travels occasionally to the place in question (for business purposes) and the journey does not form part of the trader's normal pattern of travel (if he has one).

6.1.4 Clothing

In *Mallalieu v Drummond,* a barrister claimed that the costs of her dark Courtroom dress were allowable as an expense against her professional income because she was required to wear them in Court and would not otherwise wear such clothing in her everyday life. However the Courts were not satisfied that this was the case, as they argued that she would be wearing clothing in Court in any event in order to provide her with warmth and normal decency. The clothing costs were therefore disallowed as they satisfied a private purpose.

Therefore, an accountant who only normally wears his suit when he is acting as an accountant, would not be able to claim the costs of that suit as a trading expense because he would have to wear something when meeting clients.

However, the Revenue do accept that protective clothing (hard hats, overalls, chefs aprons etc) is an expense incurred wholly and exclusively for the purposes of the trade and will allow such items. The same applies for actors' costumes.

6.1.5 Children's wages

In *Dollar & Dollar v Lyon,* the precedent was set that wages paid to the children of the trader are only deductible provided they can satisfy the "wholly and exclusively" test. We therefore need to demonstrate that if we did not employ our own children, we would need to employ somebody else's children to perform those jobs (for instance, working in the shop on a Saturday or doing a paper round). The wages paid should be at a reasonable market rate, nowadays bearing in mind the National Minimum Wage. If in the Revenue's view the children's' wages put through the accounts are simply their pocket money (as in the *Dollar & Dollar* case), the costs would not be deductible.

6.1.6 Wife's wages

Wages paid by a trader to his wife (or vice versa) are allowed provided that:

- the wages are **actually paid** (ie not just an accounts entry);
- the spouse plays an **active part** in the business;
- the wages paid are **not unreasonable** in relation to the duties performed.

Such wages paid are often intended to use personal allowances and/or lower tax bands which may otherwise be wasted.

Two queries about this point have appeared on AccountingWeb recently.

In both instances entries had been made in the accounts for wife's salary, but the amount had not actually been paid, or recorded in the accounts as a cheque payment. Payment could, have, of course been made by cash.

A number of subscribers responded to the two queries, and several interesting propositions were raised. Respondents stressed that, if the wages had not actually been paid within 9 months after the end of the accounts year then under section 36, ITTOIA 2005, the amount could not be a valid tax deduction in the trader's accounts.

The question of whether the salary had actually been paid (in cash) exercised the minds of a number of respondents. Suggestions included a signed statement or affidavit by the wife that she had received the sum claimed, a receipt for the salary signed by her, and ultimately a trip to the Commissioners with the wife as witness. All this stems from the decision in the case of Moschi v Kelly 33 TC 442, where the court held that, in order for the sum to be tax deductible, it must actually have been paid. Ideally, then, a salary to a wife should be paid monthly or weekly, and recorded as such in the books of the business.

Some commentators would go further and suggest that a PAYE scheme is adopted for the wife. Certainly, this is a good idea if she earns more than the lower earnings limit for NIC purposes, but her salary is still below the exemption limit. Qualification for State Benefits then follows. National Minimum Wage issues should not arise within a family.

The other issue is justification. Can the amount paid to the wife be justified in terms of responsibility taken, work completed and number of hours worked in a week or month? HMRC are unlikely to be able to dispute this issue if the trader can justify payment on these grounds, and the HMRC Enquiry Manual at EM3911 tends to confirm this stance.

Prudent advice to accountants and their clients, where one spouse employs the other is as follows:

(1) Establish a formula for payment based on responsibility taken, hours worked and the type of work actually completed. This may change during the month or year.

(2) Actually pay the weekly or monthly amount from the business bank account to an account in the name of the wife. It is wise to avoid a joint bank account in these circumstances.

(3) If the payments bring the wife within the lower earnings limit for NIC or actual taxability for PAYE and NIC, then establish a PAYE scheme. This involves some administrative work, but it is better to be safe than sorry.

These actions should make any scheme of payment of wife's wages watertight as far as HMRC are concerned.

6.1.7 Accountancy fees

In days gone by, it was not unknown for investigating Inspectors to review the accounts for the year following an enquiry to check up on the amount of accountancy fees claimed, the object being to disallow any additional accountancy costs incurred as a consequence of the enquiry. However, those were gentler days, and Inspectors did not always subject accounts to successive enquiries.

In today's harsher times it sometimes appears that an Inspector's (now Officer's) appetite for seeking disallowances has increased, as has the detail of enquiries and the associated costs of compliance. While this might be an impression coloured by nostalgia, it is undeniable that detailed enquiries into corporate clients remain costly and time consuming for businesses. Contentious enquiries can last for years and this is certainly so where the point at issue involves a referral to the Commissioners.

In such cases, the costs of arguing with HMRC will span several accounting periods. The authors are aware of enquiries where an Officer has sought to disallow the accounting costs claimed in the accounts for years subsequent to the enquiry while the enquiry was still continuing. HMRC's justification for the disallowance stems from TA 1988, s 74(1) on the basis that the expenditure is not 'wholly or exclusively laid out or expended for the purposes of the trade'.

But is that the correct treatment?

<u>Long standing practice</u>

'The Revenue's long standing practice' is a quote from HMRC's *Business Income Manual*, para 37850 where HMRC refers to the 1948 case of *Smith's Potato Estates Ltd v Bolland* 30 TC 267. This case stemmed from a decision by the Revenue to allow only just over half of an estate manager's remuneration in computing estates' profits for excess profits tax. The company appealed against this decision. While it was largely successful (it was held that 90% of the manager's remuneration was allowable), the company incurred expenditure on legal costs and accountancy fees of £622 in conducting the appeal. It was the admissibility of these appeal costs that became the subject of the ensuing tax case.

'Wholly and exclusively … for the purposes of the trade'

The matter considered was whether the legal and accounting costs had been incurred 'wholly and exclusively … for the purposes of the trade', the then wording of the rule 3(a) of Schedule D Cases I and II from the Income Tax Act 1918 and the current wording of TA 1988, s 74(1).

Lord Porter considered that 'the costs were incurred solely for the purpose of ascertaining a tax liability and nothing else', i.e. that in his opinion, the costs could not be said to be for the purposes of the trade.

Enquiry costs

In fairness, there has long been recognition on the part of HMRC that the costs of handling an enquiry that did not result in any additions to profits should be admissible. Indeed, this concession has also been extended to those cases which resulted in additions of a purely technical nature for the year of enquiry. This concession was recorded previously in Revenue Statement of Practice 16/91 but required some revision following the introduction of the self-assessment regime.

Tax Bulletin 37: '*Accountancy expenses arising out of self assessment enquiries*

Additional accountancy expenses arising out of an enquiry into the accounts information in a particular year's return will not be allowed where the enquiry reveals discrepancies and additional liabilities for the year of enquiry, or any earlier year, which arise as a result of negligent or fraudulent conduct. Where, however, the enquiry results in no addition to profits, or an adjustment to the profits for the year of enquiry only and that adjustment does not arise as a result of negligent or fraudulent conduct, the additional accountancy expenses will be allowable.'

The HMRC *Enquiry Manual*, at para 9010, confirms that this remains the current practice.

More than one year

HMRC's statement of practice goes beyond cases involving negligence. Where an enquiry results in additions to profits for more than one year, HMRC will seek to disallow the additional accountancy expenses arising from the enquiry, even if there has been no negligent or fraudulent conduct by the taxpayer. In effect, HMRC will admit the additional accountancy expenses only if:

- the enquiry results in no additions to profits; or
- there is an adjustment to profits for the year of *enquiry* only and that adjustment does not arise from negligent or fraudulent conduct.

Appeal costs

In contrast, HMRC consider that appeal costs do not merit any concession (see BIM, para 46455) at all. Why appeal costs are considered as being entirely different from 'enquiry costs' is not wholly clear.

'Wholly and exclusively …'

As already stated, HMRC's stance on appeal costs takes Lord Porter's dictum in the *Smith's Potato Estates* case that 'the costs were incurred solely for the purpose of ascertaining a tax liability and nothing else', to mean that the tests imposed by TA 1988, s 74(1) are not met. However, is this necessarily so?

There may be occasions when the success or failure of an argument regarding the appropriate tax treatment might be sufficient to determine whether the taxpayer would be able to continue to trade. This may not be as great a stretch as it might first appear when considering, perhaps, the application of PAYE or agency legislation to a workforce.

In most cases therefore, neither the available case law, nor HMRC's published guidance allows taxpayers the comfort of knowing when costs incurred in relation to the conduct of tax appeals will be tax deductible. Likewise, taxpayers may wonder precisely when accountancy costs incurred as a result of an enquiry into a technical tax matter which results in an appeal stop being 'allowable enquiry costs' and become 'disallowable appeal costs'.

6.1.8 Interest

A proprietor of a business may withdraw the profits of the business and the capital they have introduced to the business.

Example 1

Ms D talks to her bank manager about how well her business is doing and the manager agrees to increase her business overdraft facility by £10,000. She increases the level of her cash drawings from the business by £1,000 a month, so she is withdrawing part of her capital as well as the profits being earned by the business. Her capital account does not become overdrawn. The interest payable on the increased overdraft is an allowable deduction. **Proprietors of businesses are entitled to withdraw their capital from the business, even though substitute funding then has to be provided by interest bearing loans**. This is on the basis that the purpose of the additional borrowing is to provide working capital for the business. There will though be an interest restriction if the proprietor’s capital account becomes overdrawn.

Example 2

Mr X has taken over the family business which is a small firm manufacturing plastic dinosaur toys. It does reasonably well, making a profit of £45,000 a year. The factory unit was built 20 years ago at a cost of £150,000 and stands near the centre of town. He has it revalued and negotiates with the bank to increase the business loan facility, secured on the factory. He uses part of his drawings of £150,000 to buy a holiday home in Spain.

Bank loan			£200,000	Factory premises			£300,000
Revaluation reserve			£150,000	Plant & machinery	cost	£20,000	
Trade creditors			£20,000		less dep’n	£10,000	£10,000
				Trade debtors			£10,000
Capital account	B/F	£55,000					
	Profit for year	£45,000					
	Drawings	£150,000					
	C/F		£(50,000)				
			£320,000				£320,000

Although the bank loan is secured on the factory and is shown as a business liability in the accounts part of the money has been used to fund drawings in excess of his capital and the profits. The fact that part of the drawings were used to buy a property in Spain does not determine the tax treatment. An interest restriction is due because his drawings were in excess of the profits of the business available for drawing and the capital he had in the business.

A tax computation adjustment is required to add back interest on £40,000.

This figure is arrived at as follows. The effect of depreciation on plant and machinery needs to be taken into account as does the funding provided by trade creditors. So the assets which have been funded by the bank loan are the factory cost £150,000, plant and machinery cost £20,000, and trade debtors of £10,000, less the trade creditors of £20,000 = £160,000. As the total loan is £200,000 and only £160,000 has been used to fund the business then interest on £40,000 of the loan is not allowable as a business deduction.

Looking at it another way Mr X's capital account is overdrawn by £50,000. But the accumulated profits have been reduced by depreciation of £10,000 which is a non-cash item. His excess drawings of £40,000 must have been funded by the increase in the bank loan.

In this example the revaluation of the premises is shown as a separate revaluation reserve on the balance sheet. But it could have been treated within the capital account, to increase the proprietor's capital account balance. This would not affect the restriction of the loan interest. Mr X's capital account would be in credit by £100,000, but this would have to be adjusted by reference to depreciation and revaluation.

When examining the proprietor's capital account transactions you should draw a distinction between accumulated realised profits, both capital and revenue, on which a proprietor is free to draw and unrealised profits or losses. Unrealised profits do not represent a cash item and may never be realised. They cannot affect the level of bank borrowings. You should disregard unrealised profits or losses in considering whether a proprietor's account is overdrawn.

A revaluation of business assets (for example property or goodwill) in advance of disposal is an example of unrealised profit and should therefore be disregarded. This point was covered in Tax Bulletin, Issue No.1, page 4.

6.1.9 Termination payments

Termination payments are payments made to staff on cessation of their employment contract. In a continuing trade, the deduction for termination payments made to staff is given under s.74 as the expense will have been incurred wholly and exclusively for the purposes of the trade. This is because redundancy payments need to be made to ex-employees in order to retain the support and motivation of the remainder of the staff.

On cessation of trade we cannot argue that the redundancy expense will be incurred wholly and exclusively for the purpose of the trade because there will no longer be a trade. However, employment law may specifically require the employer to make redundancy payments. S.90 therefore allows a deduction for statutory redundancy payments made to members of staff on cessation of the trade.

If the business wants to be more generous and pay amounts in excess of statutory redundancy levels, a deduction is available under S.579. However relief is limited to 3 x statutory redundancy level. Therefore, in total, a business can obtain a deduction on cessation of the trade for termination payments up to 4 x the statutory amount - once under S.90 and three more times under S.579.

6.1.10 Pre trading expenditure

Expenses incurred in the 7 years before commencement of trade are treated as incurred on the first day of trading. Such expenses will be deducted from profits in the first accounting period, provided they are generally allowed under normal rates.

6.1.11 Post cessation expenditure

Taxpayers may claim relief for post-cessation expenses paid within 7 years of a cessation of the trade.

Expenses must be wholly incurred for a specific purpose. These specific purposes are found within s.109A, which gives relief for payments "wholly and exclusively" incurred in a variety of circumstances such as:

- remedying defective work done, goods supplied or services rendered in the course of the former trade, profession or vocation
- damages in respect of any such defective work, goods or services
- legal or other professional services in connection with any claim that the work done, goods supplied or services rendered were defective
- expenses incurred in insuring against any liabilities arising out of any such claim
- debt collection expenses - these can be deducted as can any bad debts which were not accounted for in the final accounts

Relief is given against income in the year in which the expense is actually incurred. If the expenses exceed the income for that particular year, the excess can only be carried forward against future post-cessation receipts.

The time limit for a claim for post-cessation expenses is the 31 January next following the year of payment.

6.1.12 Incidental costs of obtaining loan finance.

Bank lending fees or arrangement fees etc in connection with the borrowing of money for use in the trade will be allowed. Different rules apply for companies.

6.1.13 Wages and salaries accrued

A deduction will be allowed for **accrued** wages provided that payment is made within **9 months** of the end of the accounting period.

6.1.14 Thefts and defalcations

Allowed as a trading deduction provided such thefts etc are by **employees** (i.e. not proprietors or directors). These expenses are seen as an every day risk of running a business (see *Curtis v J & G Oldfield Ltd 1925).*

6.1.15 Training costs

The acquisition of new expertise is treated as capital. For example, assume an individual wants to trade as an accountant. The costs incurred by that individual to acquire the relevant expertise and pass the accountancy exams will not be treated as an allowable expense in arriving at his taxable profit. These costs will be incurred to enable him to trade in the first place and will therefore give him an "enduring benefit".

Ongoing, update or development training, once qualified, will be allowed as a revenue expense because there is a direct link between the expense being incurred and income being received as an accountant.

Staff training costs are always allowable as a trading expense whether this is for the staff to acquire new expertise or simply to keep up to date.

6.1.16 Use of home as office

Many sole traders, partnerships or small corporates choose to operate from home.

Whatever the chosen trading vehicle, it should be possible to establish a claim for tax relief on part of the home expenses. There is no specific legislation on this, and instead it is a question of applying general principles to create a valid claim. The HMRC manuals make several references to this subject and there is some Case Law. Recently there have been attempts by HMRC to limit the scope for employees but increase it for the self-employed. This is based on new interpretations rather than any statutory changes

Clearly it is easier to establish a claim where a self-employed person uses his home as his business base, with the usual requirement applying of the expense being wholly and exclusively incurred for the purposes of the business. Indeed there is even more scope following what is said in *para BIM47815* of the *Business Income Manual* when it refers to the 1975 case of *Caillebotte v Quinn* as the authority for being able to apportion the use and cost of a home on a time basis and to allow the expenses of the room during the hours in which it is used exclusively for business purposes.

In particular it says there can be a valid claim for apportioned mortgage interest; telecommunications (including the line rental); insurance (including a household policy); repairs and maintenance.

There are several examples given by HMRC of this new approach in para BIM47825 of which Example 6 is the most important

Example 6
Gordon, an architect, dedicates a room solely for use as his office between 9am and 5pm daily. The room contains a workstation, office furniture and storage for his drawings. He uses the room for an average of 4 hours each day, though often this is spread over his working 8 hour day as he has a number of regular site visits to make. In addition it is not uncommon for Gordon to accommodate clients in his office to discuss plans, outside of normal hours.

The room is available for domestic use outside of business hours and his family regularly make use of the room for around 2 hours each evening.

After apportioning costs by reference to the number of rooms in the house, Gordon calculates the room uses £300 of variable costs (electric and oil) and £600 of fixed costs (council tax, mortgage interest, insurance). In apportioning these costs by time Gordon claims £680 in total, made up of 4/6 of variable costs (£200) and 8/10 of fixed costs (£480).

The claim equates to 75% of the total costs attributable to the room (£680/£900), which Gordon views as a more straightforward but equally reasonable basis for future claims, should his circumstances remain unchanged.

In this example it is very relevant that Gordon's family use the room in the evening. As the room is not exclusively business, full principal private residence relief should be available when Gordon sells his home.

It is also very important that the eight hours of business use are <u>exclusively</u> business. It is this exclusivity that gives the taxpayer access to the wholly and exclusive deduction. For example, a client working on the kitchen table is unlikely to receive any "wholly and exclusive" deductions as the kitchen is presumably never used exclusively for business.

Example 6 would appear to be a reasonable starting point for use of home as office claims.

If we were to make some assumptions as regards the backing numbers for the fixed costs in example 6 the following might be reasonable:

	£
Mortgage interest (£750 per month)	9,000
Council tax	2,400
Property insurance	600
	12,000
Relating to study (5% of floor area)	600
Business proportion (8 out of 10 hours)	480

It can be seen from these backing numbers that mortgage interest is a key factor in use of home as office claims. In the above example 75% of the £480 claimed relates to mortgage interest (£9,000 x 5% x 8/10 = £360). Consequently if your mortgage is low then your use of home as office claim will be low. If however your mortgage is high then you will have a high use of home as office claim. HMRC may also be expecting home office claims to fall this year given the fall in interest rates.

In any event it is obvious from HMRC guidance that they require a more scientific approach to use of home as office.

<u>Home office for corporates?</u>

Clients trading through a company can have the same effective treatment but they need to set up a rental agreement between the company and the individual

Rental payments can prove advantageous as the company may deduct the rents in arriving at its corporation tax profit, provided that such rents do not exceed a commercial arm's length amount. It is advisable to put in place a formal rental agreement and have independent rental valuations carried out by a suitably qualified expert on a regular basis. Failure to instigate this may lead to an Inland Revenue challenge on the deductibility of the rents.

In order to prevent the loss of Principal Private Residence relief on the ultimate disposal of the home it is advisable to state in the agreement that the facilities are only let to the company for designated hours each week, for example, 9.00am to 5.00pm Monday to Friday.

It should be noted that the recipient of the rent would need to declare the rent received on their self assessment property pages. As they have a source of property income they would get deductions for any costs "wholly and exclusively" incurred for their property business. Effectively the same basis as a self employed person.

<u>Interaction with buy to let losses?</u>

Where clients have buy to let losses it should be noted that any "profit" the client makes on their use of home as office rent can be offset by any buy to let losses the client has on other UK properties. As long as the charge from individual to corporate is at market value, the home office rent is part of the client's UK property business. Hence losses on a buy to let are automatically offset against the home office profit.

6.1.17 Other sundry allowable expenses:

- trade subscriptions
- research and development costs
- business rates or business element of council tax
- costs of registering a patent
- contribution to a local enterprise agency
- donations to local charities
- salary of an employee seconded to a charity
- provisions if property computed in accordance with FRS 12
  - relating to allowable **revenue** expenditure; and
  - arising from an **existing obligation**; and
  - **accurately** computed

6.2 Sundry disallowable items

The following expenditure incurred by a trader is **not** an allowable deduction for Schedule D Case I purposes:

6.2.1 General provisions for bad debts

Any bad debts **written off** in the year are deductible. Any "**specific** provisions" (ie, where the trader can match the debt with a specific debtor) are also allowable. However if a trader makes a **general** bad debt provision (eg he does not expect 5% of his debtors to pay their bills so he writes this sum off in the P&L account), this is not allowed.

For DI purposes you should adjust for **movements** in the general bad debt provision, i.e.

- add back any **increases**
- deduct any **decreases**

6.2.2 Interest/penalties for tax offences

HMRC do not normally offer a tax incentive for breaking the law, so fines and penalties are generally disallowable.

Parking fines or speeding fines will be disallowed either under the "dual purpose" principle (i.e. the trader commits an offence in his personal capacity as a motorist rather than in the course of his trade) or because it is not an expense in the course of earning profits.

If a business reimburses personal fines of an employee, the reimbursement will give rise to a taxable benefit for the employee. As this benefit will be taxed as part of the employee's remuneration, the employer will receive a trading deduction.

6.2.3 Entertaining and gifts

Costs incurred by a trader in providing business entertaining are disallowed for tax purposes. Business entertaining means providing hospitality of any kind.

However costs incurred by an employer in providing entertainment for members of staff are specifically allowable.

Business gifts are also generally disallowed unless:

the assets gifted cost under £50; and

(ii) the gift bears the business name, logo or a clear advertisement; and

(iii) the gift does not include food, drink or tobacco.

Gifts of items which it is the taxpayer's trade to provide (for example, trade samples) are allowed.

7. Do tax credits matter?

7.1 Overview

In the current climate the advisor should also consider the impact of tax credits on their business clients.

There are two types of credit: Working Tax Credit (WTC) and Child Tax Credit (CTC). Both came into effect from 6 April 2003 replacing a number of social security benefits, such as Working Families' Tax Credit, Children's Tax Credit and Disabled Person's Tax Credit. The new tax credit system is administered by HMRC.

To claim a tax credit the individual must be over 16 years of age and normally living in the UK. Payment can also be made if at least one member of a couple works in the UK or in a Crown post overseas or is in receipt of a UK state pension.

Payment is made in respect of a 'family unit' therefore the combined income of the parents, if living together, is relevant.

7.2 Working Tax Credit (WTC)

WTC can be claimed by those aged 16 or over who are in paid employment or self employment and work over 16 hours per week, providing they also look after children. Those who work longer are entitled to more. A claimant who does not look after children has to be aged 25 or over and work at least 30 hours unless they have a disability which puts them at a disadvantage in obtaining work.

WTC is made up of a number of elements. The 2009/10 figures are set out below with the previous year's information for comparison purposes:

	2008/09	**2009/10**
	£	£
Basic element	1,800	1,890
Additional couples and lone parent element	1,770	1,860
30 hour element	735	775
Disability element	2,405	2,530
Severe disability element	1,020	1,075
50 plus 16-29 hours	1,235	1,300
50 plus element, 30 hours plus	1,770	1,935
<u>Childcare element of WTC:</u>		
Maximum weekly eligible cost for one child	£175	£175
Maximum weekly eligible costs for two or more children	£300	£300
Percentage of eligible childcare costs covered	80%	80%

If both claimants are disabled or entitled to the 50+ element then the award will include two related benefits.

These figures will be increased on an annual basis. How these elements combine to arrive at a final credit payment is dealt with below.

For the first 39 weeks of ordinary maternity leave, a claimant will be treated as being in work and able to claim WTC provided they normally worked at least 16 hours or 30 hours (whichever is applicable) immediately before going on maternity leave. This also applies employees and to the self employed.

7.3 Child Tax Credit (CTC)

CTC is paid to those, whether or not they are in employment, with children under 16. CTC continues to be paid until the 1st September following the child's 16th birthday. Some CTC may also be claimed where a child is over 16 if they are a qualifying young person. This means that they are under 20 and are in full time education (e.g. taking 'A' levels). This excludes a university course and education provided as part of an employment. A qualifying young person can also be someone under 20 who is registered with the Careers Service or Connexions Service.

CTC is available to families with an income of up to around £58,000 Additional credits are available for babies under one year and in these cases a family could have income of just over £66,000 and still be entitled to claim.

The elements which make up the CTC are as follows:

	2008/09	**2009/10**
	£	**£**
Family element	545	545
Baby addition	545	545
Child element	2,085	2,235
Disability element	2,540	2,670
Severe disability element	1,020	1,075

As can be seen from the above figures, the Government is upgrading the child element of the CTC. However, the family element and baby addition has not moved since the start of the regime.

A claim for CTC can only be made by an individual or couple who are 'responsible' for the qualifying child. To be 'responsible', the child must normally be living with the claimant. Using this definition it can be possible for grandparents to claim child tax credit for a grandchild who is living with them. If a couple are separating and a child lives with both parents, an election can be made as to who can make the claim. In the event of a dispute, the Revenue makes the final decision.

CTC will be paid in addition to child benefit, which remains a universal benefit available to all families with children.

7.4 Who can make a claim?

In determining the level of credits available for both types of tax credit, it is the income of the 'family unit' that counts towards calculating the credit available.

A 'family' can be someone on their own who is over 16, a single parent, or if the claimant is married or living with someone as husband or wife, the income of both parties is taken into account.

Gay couples are regarded as a family unit for this purpose so their income is also combined – irrespective of whether they are in a civil partnership.

A tax credit claim is provisionally based on the income which a family received in the previous year. The claim can be adjusted through the year if your circumstances change eg a new baby. The claim may also be adjusted when you confirm your income for the year – subject to the £25,000 income buffer (see later in the notes).

The tax credits operate within a series of thresholds. For example, if the annual income of a family is less than £5,220 credits are payable in full. Above these thresholds the amount of tax credit is tapered down until you get to a level of income where no credit is available.

The same thresholds normally apply for both WTC and CTC. For example, those with income under £50,000 but over £5,220 will have the maximum available award reduced by 37% of the amount by which income exceeds the first income threshold limit. Once income exceeds £50,000 the taper is set at 6.67%.

The thresholds are set out below.

	2008/09	2009/10
	£	£
First income threshold	6,420	6,420
First withdrawal rate	39%	39%
Second income threshold	50,000	50,000
Second withdrawal rate	6.67%	6.67%
First threshold for those entitled to CTC only	15,575	16,040
Income disregard	25,000	25,000

It should be noted that the £25,000 income "buffer" remains in place for 2009/10 – despite the obvious planning opportunities this presents. Initially tax credit claims are paid based on the previous years income. When the current year income is confirmed the tax credit award is adjusted. If income in the current tax year rises by less than £25,000 the current year award will not be adjusted. The increased level of income will only come into play in the following year's award.

If for example a couple earned £30,000 in 2007/08 their tax credit award for 2008/09 would initially pay out based on that level of income. In the renewal process for 2008/09 the 2008/09 income is confirmed at £38,000 on 20 July 2009. There will be no adjustments to the 2008/09 tax credit payments as the £8,000 increase is within the £25,000 buffer. The tax credits for 2009/10 will however be based on an income level of £38,000 – and subject to the £25,000 income buffer when the 2009/10 income is confirmed in July 2010.

Where the family income is over the first threshold the awards are reduced in a set order as follows:

- WTC apart from childcare;
- WTC childcare element;
- CTC apart from the family element (unless the family income exceeds £50,000).

7.5 How do we work out income?

There are detailed rules to calculate whether or not the family's income exceeds the thresholds under which a claim can be made. In general, all types of income including earned and investment income, besides certain state benefits, come into play, but non-taxable income is ignored e.g. income from tax-exempt investments.

As a consequence the claimant would need to consider such types of income as salary, wages, benefits in kind and profits from self employment. Rental income from property would be relevant but not income which is exempt under the rent a room relief.

What is required is the gross amount of income received, that is the income before tax and National Insurance contributions have been taken off. If a claimant makes contributions from his or her earnings to buy shares in the employer's company under a Share Incentive Plan (SIP), those contributions must be added back to the gross pay.

Although Statutory Maternity Pay, Statutory Sick Pay and Statutory Adoption Pay are taxable, £100 will be taken off per week from income for tax credit purposes.

Income will include taxable social security benefits, for example, Carer's Allowance (previously Invalid Care Allowance) and Incapacity Benefit paid at the long-term rate, including any Child Dependency Increases paid with these benefits. However income will not include any benefits which are not taxable, such as, Child Benefit, Attendance Allowance, Disability Living Allowance, Housing Benefit or Council Tax Benefit

7.6 Gift Aid payments

Gift Aid payments are deducted from the income figures in a claim. The gross amount of Gift Aid should be deducted from total income in accordance with s25, FA 1990. It is possible to offset Gift Aid payments made by one partner against the income of the other regardless as to whether they are married.

7.7 Pension contributions

Contributions to a pension scheme approved by the Inland Revenue (such as an occupational pension scheme, a personal pension plan or retirement annuity) are excluded from the calculation of income in tax credit claims. The claimant should deduct the gross amount paid during the year from their income. There does not seem to be any restriction to the amount of pension contributions you can deduct for tax credit purposes. Consequently practitioners should be careful when they are dealing with high earning individuals making significant contributions to their pension fund – they may be entitled to tax credits!

Illustration

Max and Martha are married with four children. Max is self employed and earns £44,000 a year. Max pays pension contributions (gross) of £250 a month.

Martha works part time (16 hours) and is earning £8,000 a year. Qualifying childcare costs are £200 a week. Max and Martha will be entitled to both the working tax credit and the child tax credit as they work for over 30 hours a week and have qualifying children.

Elements (2009/19)

	£
Basic credit	1,890
Couple element	1,860
Working at least 30 hours a week	775
Childcare element: £200 x 80% x 52	8,320
Child tax credit (4 x £2,235)	8,940
Family element	545
Maximum credit	22,330
Abatement:£(49,000 – 6,420) x 39% (see note)	(16,606)
	£5,724

Note: Income for tax credit purposes is as below:

	£
Max	
Self employed income	44,000
Martha	
Salary	8,000
Total	52,000
Less: pension contributions £250 x 12	(3,000)
Annual income	£49,000

Let us now assume that Max made an additional lump sum pension contribution of £4,000 (net) on 30 September 2009.

Element	£
Maximum credit (as before)	22,330
Abatement: £(44,000 – 6,420) x 39% (see note)	(14,656)
	£7,674

Note: Income for tax credit purposes is as below:

Max	**£**
Self employed income	44,000
Martha	
Salary	8,000
Total	52,000
Less: pension contributions £250 x 12 + £5,000	(8,000)
Annual income	£44,000

As a result of the additional pension premium, Max and Martha's tax credit claim has increased by £1,950 (£7,674 – £5,724). This equates to relief of 39 per cent on a gross pension contribution of £5,000.

If we also take into account the 40 per cent income tax relief on the contribution we have total relief of 79 per cent. The net cost of Max putting £5,000 into his pension is therefore £1,050.

When you take into account the additional tax credits for Max and Martha in 2010/11 (income does not increase by more than £25,000), tax relief on a pension contribution equates to 118%! The £5,000 reduction in income in 2009/10 will have an effective rate of relief in 2010/11 of 39% in the tax credit calculation for 2010/11. This is simply because the tax credit award in 2010/11 will be based on income of £44,000. There will be no adjustment to the initial 2010/11 award when Max and Martha confirm their income at £49,000 for 2010/11 – as they are within the £25,000 buffer. Hence 79% plus a further 39% equates to total relief of 118% on a pension contribution.

For a basic rate payer the relief is 98% (20% + 39% + 39%).

7.8 Tax credits – interaction with the Annual Investment Allowance

Harry is a self employed landscape gardener earning approximately £20,000 per year. His year end is 31 March. His wife Amelia earns £8,000 per annum working 20 hours a week for 45 weeks a year at her friends shop. The couple have two young children who are with a childminder when Amelia is working. The childminder costs £7,000 per year – nearly as much as Amelia earns but they are aware that the tax credit system covers 80% of this cost.

In September 2009 Harry is considering investing £10,000 in much needed machinery. His parents are prepared to lend him the money but they would need it repaid within two years. Harry is not sure if he can take up his parents kind offer as he sees no feasible way of repaying his parents.

Will the tax system help him?

Tax and benefit computation - purchase new equipment.

	£
Profits	20,000
Less AIA of 100% x £10k	(10,000)
Net income	10,000
Tax at 20% (post PA of £6,475)	705
NIC at 8%	343
Total Tax and NIC	1,048
Tax credits (at 2009/10 rates)	
Working Tax credit – basic	1,890
Couple element	1,860
30+ hours	775
Child Tax Credit - 2 children	4,470
Childcare costs x 80%	5,600
Family element	545
Total before abatement	15,140
Abatement	
(£18,000 * - £6,420) x 39%	(4,516)
Net award	**£10,624**

* Harry and Amelia's combined income

Tax and benefit computation – no purchase

	£
Profits	20,000
Less AIA of 100% x £nil	(nil)
Net income	20,000
Tax at 20% (post PA of £6,475)	2,705
NIC at 8%	1,143
Total Tax and NIC	3,848
Tax credits (at 2009/10 rates)	
As above	15,140
Abatement	
(£28,000 * - £6,420) x 39%	(8,416)
Net award	**£6,724**

* Harry and Amelia's combined income

Net Cost of equipment purchase

Cost of equipment	£10,000
Tax and NIC saved	(2,800)
Additional CTC award (2009/10)	(3,900)
Additional CTC award (2010/11)	(3,900)
Net cash cost of equipment	£(600)

Harry has obtained tax relief on the equipment at 106% (20% + 8% + 39% + 39%)!

Seems as though HMRC are willing to help him repay his parents!!

7.9 Anti avoidance?

There are some "notional income" anti avoidance provisions within SI 2002/2006 to be aware of but these are unlikely to apply. Notional income is income which the claimant is deemed to have for tax credit purposes and will ultimately reduce the tax credit claim.

Some clients may fall foul of these provisions if they are not taking sufficient salary and dividends from their corporate. Where there are significant loan accounts owed to the individual (following a full value incorporation for example) the taxpayer may just be living off their loan account. In these cases the anti-avoidance rules need careful consideration.

Regulation 15, SI 2002/2006 states:

'If a claimant has deprived himself of income for the purpose of securing entitlement to, or increasing the amount of, a tax credit, he is treated as having that income.'

Regulation 16 of the Tax Credits (Definition and Calculation of Income) Regulations SI 2002/2006 states:

'If income would become available to a claimant upon the making of an application for that income, he is treated as having that income.'

Regulation 17, SI 2002/2006 states:

'If a claimant provides a service for another person and:

1. the other person makes no payment of earnings or pays less than those paid for a comparable employment in the area; and
2. the Board are satisfied that the means of the other person are sufficient for him to pay for, or to pay more, for the service,

the claimant is to be treated as having such an amount of employment income as is reasonable for the employment of the claimant to provide the service.'

Regulation 17 may be relevant for clients drawing on their loan accounts.

8. Penalties for errors on returns

The 2008/09 self assessment return will be the first that is subject to the new penalty regime. The new penalty regime is significantly different to the old regime and the prospect of higher penalties for errors are very real. We therefore need to be aware of how the new regime affects our self employed clients and how we as practitioners can reduce their exposure.

The new regime replaces all penalties for inaccuracies on returns under income and corporation tax, but also under PAYE and VAT. The new penalty regime charges an increasing penalty based on the tax lost, determined by the seriousness of the behaviour of the taxpayer. There are no penalties for mistakes made in good faith, and where adequate care has been taken.

8.1 Penalty triggers

A penalty will apply when a person gives a specified document to HMRC, and the document contains an inaccuracy which is careless or deliberate and which amounts to or leads to any of the following :

- An understatement of his liability to tax;
- A false or inflated statement of a loss he has incurred, or
- A false or inflated claim to repayment of tax.

Para 2 sets out a further trigger to penalty, based on an assessment to tax issued by HMRC. When an assessment is issued by HMRC to a person which understates his liability to tax and he has failed to take reasonable steps to notify HMRC within 30 days after that it is an under assessment, he is liable to a penalty. In determining what steps were reasonable to have taken, HMRC must consider whether the person knew or should have known about the under assessment, and what steps would have been reasonable to take to notify HMRC. The taxes affected by para 2 are income tax, capital gains tax, corporation tax and VAT.

Finance Act 2008 extended the new penalty regime to all other taxes and duties with the exception of tax credits. The commencement date for the new taxes is one year later than for the main taxes listed above.

The degrees of culpability which determine the rate of penalty are set out in para 3 to Sch 24, FA 2007. They are :

- Careless – if the inaccuracy is due to failure by the person to take adequate care, or if an inaccuracy which was not careless or deliberate is discovered and the person did not take reasonable steps to notify HMRC.

- Deliberate but not concealed – if the inaccuracy is deliberate, but the person does not make arrangements to conceal it, and

- Deliberate and concealed – if the inaccuracy is deliberate, and the person makes arrangements to conceal it, for example by submitting false evidence in support of an inaccurate figure.

8.2 Amounts of penalty

The penalty rates rise according to the degree of culpability by the person. The rates of penalty are as follows :

Culpability	Penalty rate
Careless	30%
Deliberate but not concealed	70%
Deliberate and concealed	100%

The penalty rate for a penalty under para 2 (under assessment not notified) is 30%.

8.3 Potential lost revenue

The rates of penalty are applied to the "potential lost revenue". This is defined by paras 5 to 8, with para 5 applying generally. The definition is logical and states that the potential lost revenue is the additional amount payable in tax and NIC as a result of the error being corrected. However, group relief and repayments of section 419 tax are ignored when calculating the potential lost revenue.

Where there are multiple errors, and the resulting additional tax would be different depending on the order in which the errors are corrected, the legislation provides clear guidance as to how this is achieved .

Para 7 deals with the calculation of potential lost revenue where losses have been overstated. In normal circumstances, when the loss has been set off and relief gained, the potential lost revenue can be calculated as normal. However, where part of the loss has not been wholly used as relief against tax due, the amount determined by para 5 is increased by 10% of the balance of the loss (the unused portion).

Where the inaccuracy overstates a loss in a group scenario, then group relief will be taken into account when calculating the potential lost revenue, as this would give relief to the loss. Finally, the potential lost revenue in respect of a loss is nil if there is no reasonable prospect of the loss being given relief and reducing the tax liability of any person.

Finally para 8 deals with the potential lost revenue where the tax has been delayed as a result of the inaccuracy. The potential lost revenue is 5% of the tax for each year, for each year of delay, with a pro rata adjustment for part years of delay. This does not apply where there are losses which have been overstated, as para 7 takes precedence.

8.4 Disclosure

The old scheme of mitigated penalties will no longer apply, but taxpayers can reduce the gross penalty by disclosure, for which a range of reductions have been specified. Para 9 first defines a disclosure of an inaccuracy as :

- Telling HMRC about the inaccuracy,
- Giving HMRC reasonable help in qualifying the inaccuracy or under assessment, and
- Allowing HMRC access to records for the purpose of ensuring that the inaccuracy or the under assessment is fully corrected.

It further goes on to list two types of disclosure and to refer to the "quality" of the disclosure. Disclosure is unprompted if made at a time when the person has no reason to believe that HMRC has discovered or are about to discover the inaccuracy or under assessment, and otherwise is "prompted". The quality of a disclosure is determined by the timing, nature and extent of the disclosure. The following rates of penalty will apply :

Culpability	Maximum penalty (no discount)	Unprompted disclosure (minimum penalty)	Prompted disclosure (minimum penalty)
Careless	30%	0%	15%
Deliberate	70%	20%	35%
Deliberate & concealed	100%	30%	50%

Finally, the penalty calculated can be reduced by HMRC in special circumstances, but these do not include inability to pay. HMRC also have power under para 11 to stay a penalty or to

© Reed Elsevier (UK) Limited

agree a compromise with regard to penalties. Penalties under paras 1 & 2 will be reduced by any other tax geared penalty which applies in relation to the same tax.

The quality of the disclosure is determined by considering the following three factors:

- telling (potential reduction of 30%)
- helping (potential reduction of 40%)
- access (potential reduction of 30%)

The resulting reduction is applied to the difference between the maximum and minimum penalties.

Example

Fred is a sole trader who did not keep his records up to date and has not kept any details of the amount of his drawings or of payments made in cash. HMRC opened an enquiry before any disclosure was made. He cooperated fully once enquiry commenced.

The likely offence is that of lack of reasonable care and the disclosure is prompted. The maximum and minimum penalties are 30% and 15%.

Fred can reduce the maximum penalty by the difference between the maximum and minimum penalty of 30% - 15% ie 15%.

The extra 15% reduction can be achieved by gaining the maximum reduction for telling (30%), helping (40%) and access (30%). However, for the purposes of demonstrating this example, say in this case he only achieved 80%. The additional 15% is therefore limited to 80% of 15% ie 12%. The maximum penalty of 30% can therefore be reduced by 12% and so the penalty is 18%.

Guidance on making a disclosure (from Compliance Handbook)

CH82440 explains what is mean by "telling". Telling includes :

- admitting the document was inaccurate or that there was an under-assessment
- disclosing the inaccuracy in full
- explaining how and why the inaccuracy arose.

The quality of the disclosure and the rate of discount therefore available for telling depends on the disclosure being given in full, essentially at the outset, subject to the complexity of the case.

CH82450 gives more guidance on "helping". Helping includes :

- giving reasonable help in quantifying the inaccuracy or under-assessment
- positive assistance as opposed to passive acceptance or obstruction
- actively engaging in the work to accurately quantify the inaccuracies
- volunteering any information relevant to the disclosure.

However, the judgement of the quality of "helping" will depend on the circumstances and capabilities of the individual concerned.

Finally, CH82460 explains "giving access". Giving access includes a person responding positively to requests for information and documents and allowing access to :

- their business and other records
- other relevant documents.

Access is needed to ensure that the inaccuracy or under-assessment is fully put right and is more than simply complying with requests for information.

Prompted and unprompted disclosure

The law states that disclosure is ***unprompted*** if made at a time when the person has no reason to believe that HMRC has discovered or are about to discover the inaccuracy or under assessment, and otherwise is ***prompted***.

The guidance (CH 82421) provides the following to an officer to determine whether a disclosure is prompted or unprompted :

Whether a disclosure is prompted or unprompted is an objective test. It is not what the person believed but what the particular facts and circumstances gave him reason to believe.

A national campaign highlighting an area of the trading community on which HMRC will be concentrating would not stop a disclosure from being unprompted. However a disclosure would be prompted if a person made the disclosure after :

- we had contacted them to tell them we wished to make a compliance check of their return, or
- we had arranged to visit their premises to undertake a compliance check of their records.

It will be exceptional for a disclosure to be unprompted if a compliance check is in progress. It will be unprompted only if the disclosure is about something the compliance officer has not discovered or is not about to discover.

During a compliance check (e.g. VAT assurance, employer compliance) if a disclosure is related to the subject matter being reviewed then it will be considered to be a related disclosure and therefore prompted.

Some companies will be in continuous dialogue to share a Risk Profile with HMRC.

A disclosure can be unprompted if it relates to an

- an area identified by the company, or
- an area that has not been raised by us as a specific concern by us.

A person is only able to disclose something they know is wrong. They may be genuinely unaware that they have done anything wrong. However if the person has been careless, for example by not taking advice when they should have, then on challenge the disclosure cannot be unprompted. An unprompted disclosure can be made for both inaccuracies and under-assessments.

Examples of prompted and unprompted disclosures

Example 1
Jemima returned a capital gain which is the subject of a compliance check. There is no intention to expand the scope of the compliance check during the review. She discloses that she has not declared her car benefit. This is an unprompted disclosure.

Example 2
During a VAT assurance visit considering the credibility of Alphonse's sales records, he discloses that his sales have also been understated for income tax. This would be related to the subject under review and so is a prompted disclosure.

Example 3
During an Employer Compliance review the employer makes a disclosure that the basis of the transfer pricing calculation for Corporation Tax is wrong. This is unrelated to the subject under review and so there is an unprompted disclosure.

8.5 Suspended penalties

Part 3 of the Schedule sets out the procedure for assessment, appeal and similar. This includes a further new development which is the power for HMRC to suspend a penalty for careless inaccuracy.

HMRC may notify a taxpayer that his penalty (all or part of it) has been suspended for a period of up to two years, and will set conditions of the suspension. However, the power to suspend a penalty will only be available if compliance with a condition of the suspension would help the taxpayer to avoid becoming liable for further penalties for careless inaccuracies.

At the end of the period of suspension, if HMRC are satisfied that the conditions of the suspension have been complied with then the suspended penalty will be cancelled; if the conditions have not been complied with, the suspended penalty will become payable. If during the period of suspension a further penalty becomes payable under para 1 (for an inaccuracy in a return) then the suspended penalty will also become immediately payable.

8.6 Errors when an agent is acting

Part 4 includes other miscellaneous provisions in relation to penalties. It extends the giving of a document to HMRC in para 1 to the authorisation of an agent to give the document on behalf of a taxpayer. The agency provision also applies to under assessments of tax, under which someone authorised to act on P's behalf in relation to tax is deemed to act in the taxpayer's stead in failure to promptly notify an under assessment.

The law states that a taxpayer is not liable to a penalty in relation to anything done or omitted by his agent if HMRC is satisfied that the taxpayer took reasonable care to avoid an inaccuracy. This would mean that the taxpayer would need some evidence that he took reasonable care over his tax affairs.

8.7 Officers of companies

Where a company is liable to pay a penalty for a deliberate inaccuracy which was attributable to an officer of the company, the officer as well as the company shall be liable to pay the penalty, and HMRC may seek recovery of such proportion of the penalty from the officer as they may specify. However, no more than 100% of the penalty assessed can be collected in this way, between the company and the officer. Officer in this context means director, shadow director and secretary.

8.8 Partnership returns

The person delivering the return in the case of a partnership return would be the firm. When an inaccuracy affects the amount of tax due by a partner, the partner is also liable for a penalty – this is termed the partner's penalty. The nominated partner would remain liable for the penalty on the firm. Potential lost revenue is calculated separately for the penalty on the firm and each partner's penalty, by reference to the proportions of any tax liability that would be borne by each partner.

8.9 Reasonable care

All of the penalty reform depends upon the definition of reasonable care adopted by HMRC. Guidance on this aspect was issued on 1 April 2008 as the first release of a new HMRC manual – the Compliance Handbook Manual - which includes significant guidance on "reasonable care".

© Reed Elsevier (UK) Limited

Guidance on the meaning of reasonable care

This appears in CH81120. It sets out the principle that reasonable care will vary depending on the capabilities and circumstances of the individual acting, and in particular on the type of business or transaction he is dealing with. Thus :

- An unrepresented taxpayer will have a lower expectation of his capabilities than a represented taxpayer
- Where a complex or unusual transaction is to be undertaken, the taxpayer is expected to take extra care
- Reasonable care extends to the records that a taxpayer keeps to enable him to report his income and gains correctly
- Reasonable care can also extend to the systems in place to ensure that tax is dealt with properly in relation to business transactions.

Uncertainty and reasonable care

There is particular guidance for those undertaking a transaction about which the tax outcome is uncertain:

"In HMRC's view it is reasonable to expect a person who encounters a transaction or other event with which they are not familiar to take care to find out about the correct tax treatment or to seek appropriate advice.

If after that the person is still unsure they should draw attention to the entry and the uncertainty when they send the return or document to us. In these circumstances the person will have taken reasonable care to draw our attention to the point and if they are wrong they will not have been carelessly so."

Thus, disclosure, which is normally considered in the context of the issue of discovery, now will extend to the issue of penalties where it is found that a transaction or event has been incorrectly reported or taxed. The proper disclosure of the transaction and the uncertainty relating to it will achieve the "reasonable care" required in order for the taxpayer to avoid a penalty should the treatment prove incorrect. The guidance then provides some examples of when reasonable care has been applied and no penalty is due :

"Examples of when a penalty would not be due include

- a reasonably arguable view of situations that is subsequently not upheld
- an arithmetical or transposition inaccuracy that is not so large either in absolute terms or relative to overall liability, as to produce an obviously odd result or be picked up by a quality check
- following advice from HMRC that later proves to be wrong provided that all the details and circumstances were given when the advice was sought
- acting on advice from a competent adviser which proves to be wrong despite the fact that the adviser was given a full set of accurate facts.

Reasonable care – agents acting

When an agent is acting on behalf of a client, the taxpayer must still exercise reasonable care, and must be able to evidence this to the officer concerned. This might involve providing access to correspondence between the agent and his client. The guidance states that reasonable care when an agent is acting includes:

- Appointing an agent competent to deal with his affairs,
- Giving the agent all of the relevant information, and
- Checking the return, as far as possible, before it is submitted.

Agents will want to review their process and procedures to establish how these aspects can be evidence and to provide clients with the support that they might need.

For example when sending a client the 2008/09 self assessment return it would be advisable to send them the summary sheet generated by the tax software system with an approval statement at the bottom for the client to sign. The client is far more likely to understand the summary sheet showing all forms of income, gains and deductions than they are the tax return. They are therefore more likely to review the summary sheet and spot obvious errors – for example no overseas rent included in their return because they did not tell you about their new source of income!

We need to counter clients signing returns without reviewing the return for obvious errors – the summary sheet may help.

Finally, it is worth considering the examples of situations in which the taxpayer failed to take reasonable care. They are at CH81142.

Example 1
Paul, a self employed plumber, does not pay much attention to his record-keeping responsibilities and has no structured system for making sure that his records are accurate.

When Paul completes his income tax return he cannot be certain that his figures are correct and is unable to check them. This attitude towards record keeping indicates a lack of reasonable care.

Example 2
Chandra, a shopkeeper decides to replace his old van with a new vehicle. He buys an estate car so that he can use it for business trips to his local cash and carry, and also uses the vehicle for personal use in the evenings and weekends.

Chandra is not sure about what input tax he can claim for his vehicle, but he doesn't contact his accountant or HMRC for advice, and wrongly claims all the input tax he paid on the car. This indicates at least a lack of reasonable care.

Example 3
A&B Ltd, a large company with a substantial advertising budget, does not have procedures to identify the entertaining element of advertising costs. So any expenditure on advertising is included in full in the advertising account, with no way of cross-checking how much of the expense relates to disallowable entertaining.

This would at least indicate failure to take reasonable care and could be shown to be deliberate. A&B Ltd's basic systems and procedures are inadequate to give appropriate levels of assurance.

Example 4
During an Employer Compliance review the compliance officer advises Able Ltd that reimbursement of private phone bills should be dealt with through the payroll and that PAYE and NICs must be deducted accordingly.

When Able Ltd sends you its next end of year return you carry out a review and discover that the company has not followed the advice given by the compliance officer and the end of year return is wrong as a result.

This indicates that Able Ltd has at least failed to take reasonable care because it has ignored the advice given by HMRC.

Example 5
On several consecutive VAT return periods Whizz Ltd tells you after the end of the return period that the return was wrong and gives you the correct figures.

Whizz Ltd's systems are not adequate enough to produce correct figures for the return by the end of the return period and this repeated inaccuracy may be seen as at least a lack of reasonable care.

8.12 Correcting VAT errors – the penalty implications

Under the new penalty regime for inaccuracies on returns and documents disclosure plays a crucial part in the design of the new penalty regime. There is an important and complex interplay with the correction of VAT errors – previously known as voluntary disclosure, but now referred to as "correction of errors".

Where a client has made a culpable error, that is an error through failure to take reasonable care over his tax affairs, or a misdeclaration on a return or document that is deliberate, disclosing the inaccuracy can result in a significant reduction in the penalty tariff. Unprompted disclosure of an error, that is not made under fear of discovery can result in the penalty for careless error being reduced to zero, assuming that the disclosure is prompt and complete.

However, this has important implications for the future of dealing with VAT errors, particularly in view of the new limit applying to the correction of VAT errors from July this year.

When a trader has made VAT errors which has subsequently been discovered, the errors can often be corrected on the next VAT return, provided that the total value of errors they seek to correct is less than the specified limit. The limit applying until July 2008 was £2,000; this means that if the total net value of errors to be corrected is less than £2,000 the errors can simply be corrected by making an entry on the next VAT return. Default interest does not apply to errors corrected in this way.

For errors in excess of this amount, the error must be disclosed separately to HMRC either by completing form VAT 652 or by writing to HMRC VAT Regional Business Advice centres. Once the error has been corrected by an assessment (which is issued on receipt of the notification) default interest will also apply to any late paid VAT as a result of the error.

The limit of £2,000 has been replaced for VAT accounting periods commencing on or after 1 July 2008. For these VAT periods, errors of £10,000 can be corrected on the VAT return by all traders. For larger businesses with errors in excess of this sum, the limit is 1% of current turnover up to a maximum of £50,000. The turnover for these purposes is the box 6 figure on the return on which the error is to be corrected. Thus, if box 6 exceeds £1 million for the current VAT period, the error may still be corrected on the return provided it does not exceed the lower of 1% of box 6 or £50,000. Errors in excess of the new limits must be separately disclosed to HMRC as before, using form 652. Default interest will not apply to errors corrected on returns, but will apply to errors which are separately notified.

Traders should however be aware that adjusting an error through the VAT return is not disclosure for penalty purposes. Consequently if the trader has not taken reasonable care any error should be disclosed to HMRC – irrespective of the fact that it has been adjusted for through a VAT return.

EAST MIDLANDS CIOT & ATT – Events for 2009/2010

Date	Details	Timetable	Venue
Wednesday 23 September 2009 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Advising the Self-Employed** Dean Wootten FCA CTA Principal Tutor at Tolley Tax Training **Branch AGM 4.15pm to 4.30pm**	4.00pm - Registration & refreshments **4.15pm – Branch AGM** 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Premier Travel Inn, Braunstone Lane East Leicester LE3 2FW
Wednesday 7 October 2009 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Employment Status & IR35 Update** David Smith LL.B (Hons) CTA (Fellow) Accountax Consulting	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Best Western Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire. LE14 3BH
Wednesday 4 November 2009 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Tax Investigations** Mark Morton BA ATII ATT Senior Tax Lecturer for Mercia	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	The Carriage Hall Nr Perkins Restaurant Station Road, Plumtree Nottingham. NG12 5NA
Tuesday 24 November 2009 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Practical Aspects of Employment Related Securities & Share Options** Paul Giles CTA Solicitor	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Ramada Jarvis Nottingham Junction 25 M1 Bostock Lane Long Eaton Nottingham NG10 4EP
Wednesday 10 February 2010 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**The Tax Aspects of Marriage Separation & Divorce** Rebecca Benneyworth BSc FCA	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Ramada Jarvis Nottingham Junction 25 M1 Bostock Lane Long Eaton Nottingham. NG10 4EP
Tuesday 30 March 2010 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Corporation Tax Update** Giles Mooney BSc ACA CTA Partner at PTP Group	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Best Western Leicester North((formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire. LE14 3BH
Wednesday 21 April 2010 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**IHT & CGT Update** Francesca Lagerberg FCA CTA (Fellow) Head of the National Tax at Grant Thornton UK LLP	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	Premier Travel Inn, Braunstone Lane East Leicester LE3 2FW
Tuesday 25 May 2010 4.00pm – 8.00pm **Cost: £40.00** CPD Hours: 3	**Finance Bill 2010** Robert Jamieson MA FCA CTA (Fellow) Mercer Hole Past President of the Chartered Institute of Taxation	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.30pm - Lecture resumes 8.00pm – Close	The Carriage Hall Nr Perkins Restaurant Station Road, Plumtree Nottingham. NG12 5NA
June 2010 6.00pm – 8.00pm **Cost: £15.00** CPD Hours: 1.5	**Topical Tax Issues** Andrew Hubbard BMus PhD ATT CTA (Fellow) Tax Director, Tenon Group PLC	6.00pm - Registration & refreshments 6.30pm - Lecture starts 7.45pm - Questions 8.00pm – Close	PricewaterhouseCoopers Offices Donington Court,Pegasus Business Park, Castle Donington, Derbyshire. DE74 2UZ

The Branch Committee reserves the right to alter the above programme without prior notice.

For more details of any of the above events or to book a place please contact the Programme Secretary, Ken Curran at The Cottage, Donkey Lane, Bradmore, Nottingham. NG11 6PG.

Telephone: 0115 921 5590or E-mail: ken@curranandco.co.uk