

# McBrides

## Finance

## and

## Business

Thursday, 6 October 2011

# FaB

Finance and Business  
*for Breakfast*

# agenda

- welcome & introduction – Nigel Kimber, McBrides
- business tax – Terry Baldwin, McBrides
- business development – Alistair Brew, Business Growth Fund
- questions & answers

## Additional documentation:

- McBrides Quarterly Tax Pack

# FaB

Finance and Business  
*for Breakfast*

Thursday, 6 October 2011

**McBrides**

chartered accountants  
registered auditors  
tax consultants  
business advisers  
corporate finance

# agenda

- welcome and introduction – Nigel Kimber, McBrides
- business tax – Terry Baldwin, McBrides
- business funding – Alistair Brew, Business Growth Fund
- questions & answers

# business tax issues

- Buying out a shareholder –purchase of own shares or newco route?
- Entrepreneur's relief – avoiding the pitfalls
- Share incentives for key employees – options or shares?

# buying out a shareholder – main issues

- Agreeing the price
- Finding the money
- Who will purchase the shares?
- Timeframe for payment
- Securing favourable tax treatment

# buying out a shareholder – company purchase

- Sufficient distributable reserves?
- Confirming CGT treatment for the vendor
  - advance clearance
  - numerous conditions
- ½% stamp duty on the shares purchased

# buying out a company – company purchase

- Purchase effected for the benefit of the company's trade
- Not for tax avoidance purposes
- Must have owned the shares for five years
- Vendor's shareholding reduced by at least 25%
- Must not be connected with the company immediately afterwards

# buying out a shareholder – newco route

- Continuing shareholders exchange shares
- Vendor receives cash, loan notes, debt, etc
- Financial assistance prohibitions relaxed
- Loan notes and debt repayments funded via upstream loans or dividends
- Doesn't 'use up' reserves
- Additional associated company for CT?
- ½% stamp duty payable on value of company

# entrepreneur's relief – avoiding the pitfalls

- What is ER?
- What limits are there?
- When does it apply?
  - a) disposal of an interest in a business
  - b) disposal of qualifying shares or securities
  - c) disposal of assets associated with a disposal within (a) or (b)

# entrepreneur's relief – disposal of shares

## Main conditions for relief

Throughout the year before disposal:

- the company is a trading company or holding company of a trading group
- the vendor owned at least 5% of the OSC and voting rights
- the vendor was an officer or employee of the company

# entrepreneur's relief – disposal of shares

## Potential pitfalls

- Non-trading activities
- Shares owned by non-employee spouse
- Shares acquired on exercise of options
- Dilution following exercise of options
- Preference shares and debentures
- Share for share exchange – disapplication election?
- Share for loan note exchange – disapplication election?
- Deferred consideration
- Charging rent on premises owned personally

# share incentives for key employees – options or shares?

- Which incentivises most?
- Cost to the company/existing shareholders?
- What is the acquisition price?
- How will the employee fund the share acquisition?
- What if the employee leaves or dies?
- Should the shares rank equally with existing shares?
- When can options be exercised?
- **WHAT ARE THE TAX IMPLICATIONS!**

# share incentives for key employees – options or shares?

## Basic tax implications

- Shares acquired at less than current market value give rise to an income taxable benefit
- Shares subject to restrictions or conditions can give rise to income taxable benefit on ‘lifting’ or disposal
- PAYE and NIC may be payable on profit realised on disposal

THE EMPLOYMENT RELATED SECURITIES CODE IS VERY COMPREHENSIVE

# share incentives for key employees – options or shares?

## EMI share options

- Highly tax favoured
- Basically, no tax on grant or exercise, CGT on disposal
- Very flexible re: exercise, performance, conditions
- No cash outlay until exercise
- No share rights until exercise
- **COMPANY TAX DEDUCTION**

# share incentives for key employees – options or shares?

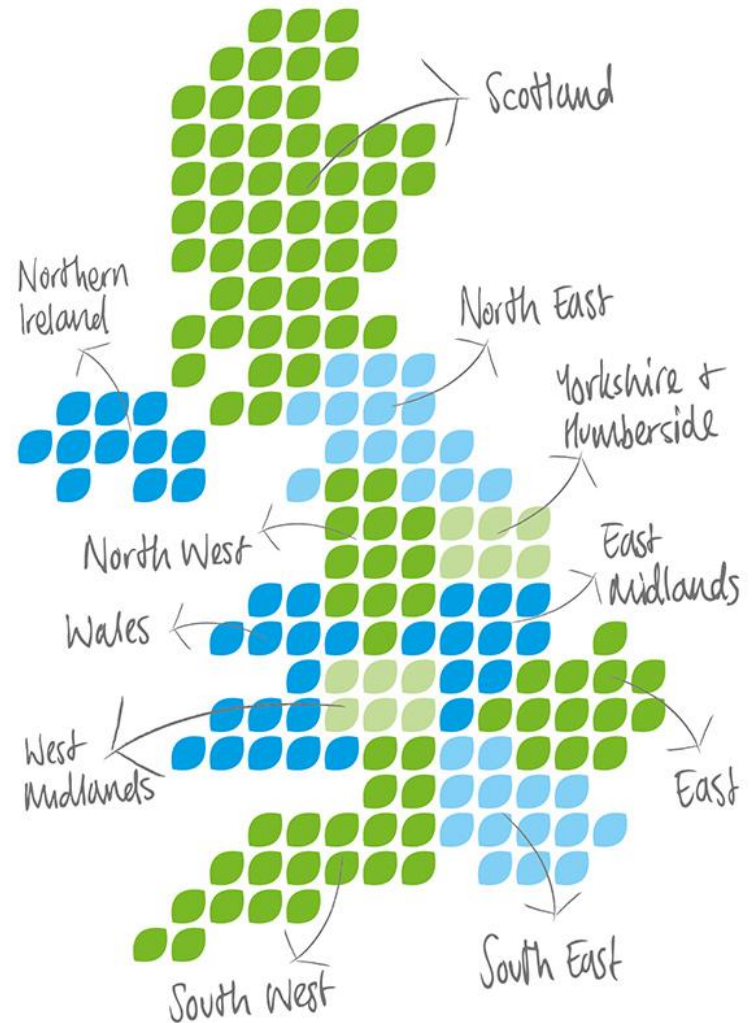
## Partly paid shares

- Employee subscribes for new shares at MV
- Only a small part of the subscription price payable
- Balance paid when a ‘trigger’ event occurs
- No taxable benefit
- Small cash outlay upfront
- Full dividend and voting rights
- Liable for balance or price

## Introduction to the Business Growth Fund

*McBrides FaB Meeting  
6<sup>th</sup> October 2011*

# McBrides



## Our Mission

***Our mission is to recognise and invest in UK companies that have real potential to succeed. Our ambition is nothing less than creating the household business names and listed companies of tomorrow.***

## Origins and Aim of the Business Growth Fund

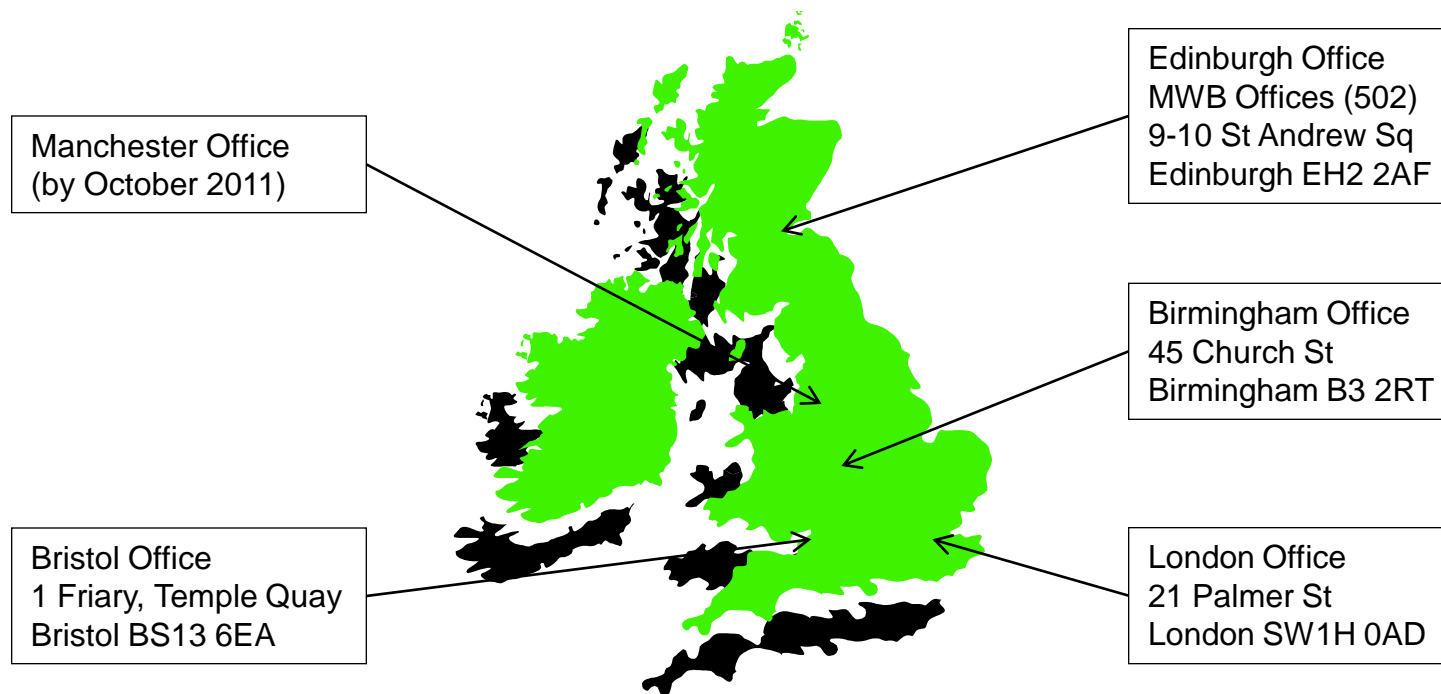
- The Rowlands Review (Nov 09) reconfirmed a gap in the provision of £2m - £10m of growth capital
- 'Project Merlin' discussions led to the BGF being established in April 2011 by five of the largest UK banks with £2.5bn of committed capital



- The aim of the BGF is to bridge the equity funding gap and support established, growing businesses
- BGF is a commercial business, independent of Government, with autonomous decision making
- Exciting once in a generation opportunity

## Locations

- The BGF is a national organisation with a regional network of offices to drive local deal origination, execution and on-going support



## Investment focus

- Growth Capital or Acquisition Finance for privately owned UK SMEs
- £2-10m equity for a minority stake (typically 20%-40%)
- No buy-outs, but some change of ownership possible as part of a Growth Capital deal
- Flexible investment structures using equity and loan notes
- Not reliant on bank debt but well placed to work with the banks
- Invested off BGF balance sheet and can invest for the longer term
- Board seat always taken, but not to run the business

## A true partner for families, entrepreneurs and management

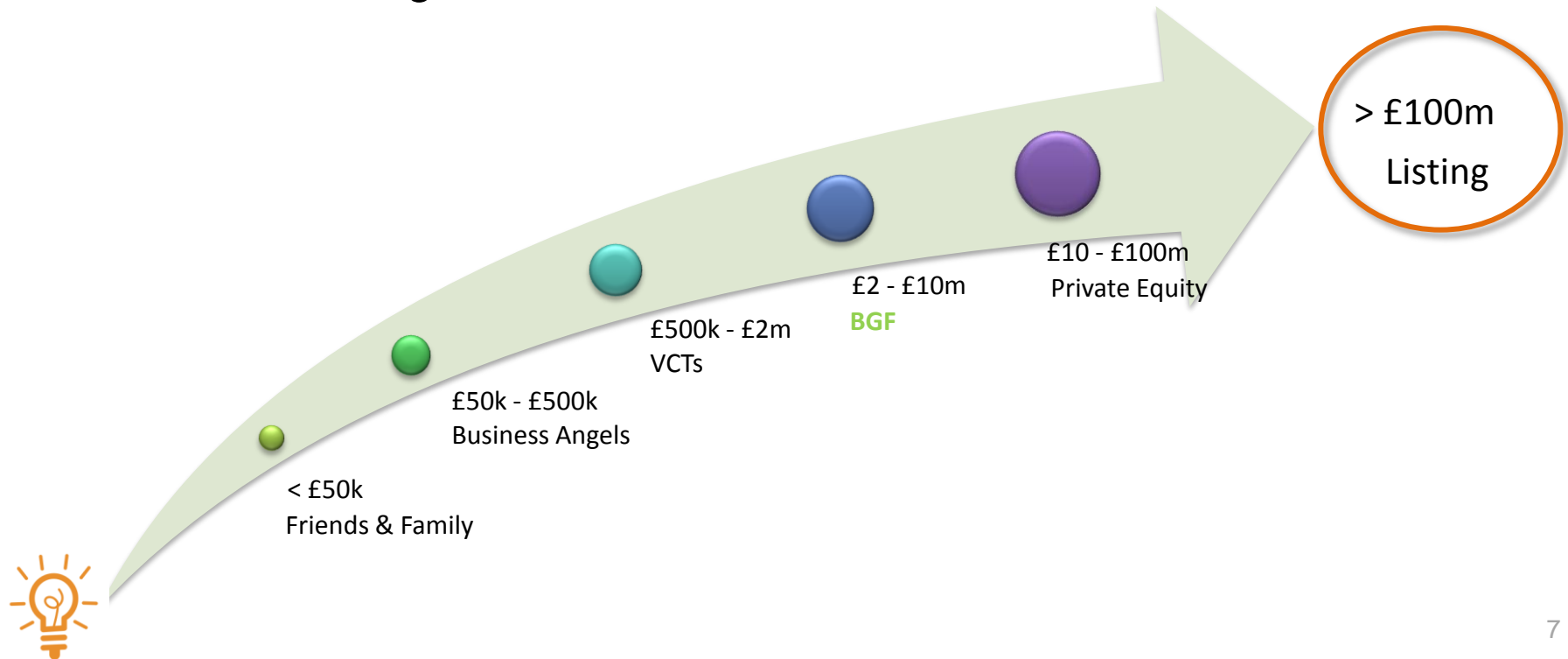
As a minority investor the BGF will work in partnership with the owners based on trust and alignment of interest to:

- Provide advice on using the right finance to fund growth
- Help determine the right capital structure, including unlocking bank financing, whilst maintaining a conservative approach
- Get involved at board level not day-to-day operations
- Provide practical support through a network of business partners
- Provide guidance on strategy for growth, both organic and via acquisition
- Help manage succession and development of the business as it grows
- Invest for the long term

## How does the BGF work with other providers of equity capital?

The **BGF** will:

- “Plug the gap” between Angel/VCT/Private investors and Private Equity
- We can co-invest and consider ourselves to be an attractive co-invest partner with deep pockets and a public mandate
- Stimulate and grow demand overall for investment into UK SME’s



## Key investee company characteristics

- Established, profitable UK based business with demonstrable growth potential
- Turnover likely to be in the range of £5m - £50m
- Generalist sector focus but heavily growth orientated;
  - Only excluded sectors are financial services (which compete directly with our shareholders) and property
- Incentivised management team with a strong track record
- Generating strong margins with a scalable business model
- Not start ups, early stage or turnarounds

## Investment Process

- BGF will source its deals both on a proprietary basis as well as via intermediaries
- One nationwide team approach to deal process with an internal Investment Committee involved in each deal from the outset
- Early feedback with suggestions on alternative options if it is a no
- Due diligence from professional services firms as well as our own in house resource and network of business partners
- Standardised approach to legal agreements
- Anticipate 3-4 month deal process per investment

## Experience to date

- Team coming together – people from different backgrounds
- Non-Executive Directors now appointed
- Infrastructure being built at the same time: systems and network
- Wider discussions taking place with banks, business organisations and Government
- Good deal flow: two deals close to completion
- The market does see us as different
- We expect to make a major impact in 2012

## The BGF is NOT

- Owned by the government or funded by the taxpayer
- A Quango
- Managed by the banks
- A lender
- A private equity firm focussed on buy-outs
- A venture capital company focussed on start ups

## The BGF is

- An independent company
- Managed autonomously
- Funded from its own balance sheet
- A provider of long term equity capital
- A partner for UK smaller businesses
- A partner for entrepreneurs and angels

**McBrides**



**Any Questions?**

# QUARTERLY TAX UPDATE BRIEFING

## INDEX

<b>CORPORATE TAX</b> .....	1
1. Corporation Tax: mandatory online filing and the end of a company's life .....	1
2. Corporation Tax: mandatory online filing and the end of a company's life .....	2
3. Cold comfort for corporates.....	7
4. Practice guide: How to handle purchase of own shares .....	12
<b>BUSINESS TAX</b> .....	17
5. HMRC 2010-11 report and accounts.....	17
6. Hold on to 10% .....	18
7. Best of both worlds .....	24
8. You're trading!.....	30
9. Reasonable excuse scorecard: Taxpayers 11 HMRC 7 .....	34
10. Tribunal slams HMRC's PAYE late penalty regime .....	38
11. Revenue & Customs Brief 28/11 - VAT: Changes to the treatment of certain supplies made by employers under salary sacrifice arrangements following the CJEU Judgment in Case C-40/09.....	40
<b>PERSONAL TAX</b> .....	44
12. Industry's reaction to Government consultation on residency rules .....	44
13. The proposed statutory residence test .....	45
14. Christopher Lunn & Company ("CLAC").....	50
15. Is it too easy?.....	52

# CORPORATE TAX

## 1. Corporation Tax: mandatory online filing and the end of a company's life

The basic premise is always that a company must deliver a Company Tax Return to HMRC if it receives a 'notice' to do so (FA 1998, Sch 18 Para 3).

Insolvent companies in any form of formal winding up or administration procedure are, however, specifically exempted from the requirement to file online.

But that exemption does **not** apply to companies moving towards informal striking off or during a solvent Members' Voluntary Liquidation (MVL).

Such cases can therefore present practical difficulties and HMRC has therefore issued guidance.

### **1. The basic proposition for solvent companies**

An accounting period of the company ends when it ceases to trade or ceases to be within the charge to Corporation Tax.

In the case of an MVL, an accounting period also ends immediately before the winding up starts. So there will nearly always be a final accounting period, running from the day after the end of the last normal accounting period and ending with the last day of trading or the day before the commencement of the liquidation. This is referred to below as the 'stub period'.

Typically, HMRC is made aware of the cessation and intention to seek striking off at a point when the notice for the last normal accounting period has been issued.

In such cases, in principle the company must comply with the requirements of the notice and deliver a full Company Tax Return for that period, including the Companies Act individual accounts and tax computations both tagged in iXBRL.

**So HMRC says it will insist on a full online Company Tax Return for any accounting period for which the return will be due before the date of striking off, where the notice to make a return has already been issued.**

### **2. Agreeing figures before the filing date to allow striking-off or liquidation**

If a company asks HMRC to agree to its striking off before the statutory filing date for the return for the last normal accounting period - that is, at a time when that return is still not legally due and when no notice will have been issued requiring a return for that period - HMRC will only normally insist on a full online Company Tax Return where it considers there are reasonable grounds for considering that there is a risk of tax loss, if they do not have the opportunity to review a full Company Tax Return. HMRC will object to the striking off until they receive the full return, in such cases.

(HMRC will also need to agree the position for the stub period following the last normal accounting period up to the proposed date of striking off or commencement of liquidation.)

Where HMRC doesn't think there is a material risk of loss of tax, they will seek to agree the tax liability of the company for the last outstanding accounting period, as well as for the stub period, on the basis of management accounts or similar financial statements and tax calculations based on them. HMRC will also accept the relevant information on paper or by other agreed means provided it meets their needs.

## 2. Corporation Tax: mandatory online filing and the end of a company's life

### Summary

Companies tend to have trouble producing full Company Tax Returns at the end of their lives. They face further specific problems during any form of formal 'winding up' and the move to mandatory online filing brings these issues into sharp focus. For this reason, insolvent companies in any form of formal winding up or administration procedure are exempted from the requirement to file online. But that exemption does not apply to companies moving towards informal striking off or during a solvent Members' Voluntary Liquidation (MVL).

These cases present some practical difficulties. This guidance sets out the issues and gives detailed guidance about the approach that HM Revenue & Customs (HMRC) will take in dealing with them.

### Background context - mandatory online filing

A company must deliver a Company Tax Return to HMRC if it receives a 'notice' to do so (Finance Act 1998, Schedule 18 Paragraph 3).

The notice is contained in form CT603 which HMRC issues automatically to every company which they believe to be active. It is this notice which defines the required content of a Company Tax Return. In particular, the notice requires the return to include 'a copy of the accounts of the company for the period covered by the return and computations showing how the specified information (that is, the entries on the Company Tax Return form CT600) has been calculated from the relevant figures in the accounts'.

The meaning of 'accounts' is defined at length in the notice. For a normal UK resident company, it means the company's 'individual accounts' which it is required to prepare under S394 of Companies Act 2006.

From 1 April 2011, nearly all Company Tax Returns for periods ending after 31 March 2010 have to be delivered to HMRC online. You will find more information on this - including the secondary legislation (Regulations and Board's Directions) - on the HMRC website.

[More about Corporation Tax online filing and electronic payment](#)

### Insolvent company exemptions from online filing

There is a legal exemption for insolvent companies - companies do not have to deliver their Company Tax Returns online if they are subject to a winding up order or are in formal administration or administrative receivership. This legal exemption also extends to creditors' voluntary liquidations, company voluntary arrangements and provisional arrangements under a court order. The full details are set out in Regulation 3(10) and (10A) of the Income and Corporation Taxes (Electronic Communications) Regulations 2003, inserted by Statutory Instruments made in December 2009 and December 2010.

You can find the full texts of the various Statutory Instruments on the HMRC website.

[Corporation Tax online filing and electronic payment](#)

So, once any of these forms of legal process is in effect, the insolvent company can choose whether to deliver its return online or on paper.

This exemption applies in relation to any return, for any period, while the company is subject to the formal insolvent winding up procedure. So it applies to any outstanding Company Tax Returns for periods before the commencement of the winding up and appointment of the insolvency Practitioner (IP) as well as to periods within the period of the winding up procedure.

This legal exemption of insolvent companies from mandatory online filing means that we can and will continue the practice of accepting an 'informal return' from liquidators, for any period, as set out in the Company Taxation Manual.

Read more about the legal exemption of insolvent companies

### **Example:**

Belly Up Ltd is insolvent and has not prepared formal Companies Act individual accounts or delivered outstanding Company Tax Returns for periods before the commencement of the winding up or within the period of the winding up procedure. HMRC will accept formal returns online or on paper, or informal returns on paper for any of those periods.

### **Solvent companies - informal dissolution and MVL**

The exemption does not apply to solvent dissolutions where the company seeks informal striking-off or enters a MVL. There may be particular risks as a result of the cessation and striking off which need consideration, so a full Company Tax Return may be essential.

So HMRC's starting point has to be that the normal filing requirements for a solvent company apply to the return for any period for which HMRC issue a 'notice to deliver a Company Tax Return' even in an MVL where an IP has been appointed. By law, HMRC require a full Company Tax Return online in accordance with the requirements of the notice for that period. However, these cases present practical difficulties which the following guidance addresses.

### **The basic proposition for solvent companies**

An accounting period of the company ends when it ceases to trade or ceases to be within the charge to Corporation Tax. In the case of an MVL, an accounting period also ends immediately before the winding up starts. So there will nearly always be a final accounting period, running from the day after the end of the last normal accounting period and ending with the last day of trading or the day before the commencement of the liquidation. This is referred to below as the 'stub period'.

Typically, HMRC is made aware of the cessation and intention to seek striking off at a point when the notice for the last normal accounting period has been issued. In such cases, in principle the company must comply with the requirements of the notice and deliver a full Company Tax Return for that period, including the Companies Act individual accounts and tax computations both tagged in eXtensible Business Reporting Language (XBRL).

### **Example**

Ready2Retire Ltd is solvent and the directors want to close down the business and settle in Spain.

- the company's normal accounting date is 31 December
- the CT603 notice to deliver a return for accounting period ending 31 December 2010 is issued in January 2011
- the company ceases activity on 1 April 2011 and it notifies HMRC that it intends to seek voluntary striking off
- the issued notice requires the company to deliver a full Company Tax Return for the last normal accounting period to 31 December 2010, including Companies Act individual accounts and tax computations both tagged in XBRL, online

In such cases, HMRC will insist on a full online Company Tax Return for any accounting period for which the return will be due before the date of striking off.

### **Practical situations - how HMRC will deal with cases**

#### **Agreeing figures before the filing date to allow striking-off or liquidation**

A company will often ask HMRC to agree to its striking off before the statutory filing date for the return for the last normal accounting period - that is, at a time when that return is still not legally due. HMRC will also then need to agree the position for the stub period following the last normal accounting period up to the proposed date of striking off or commencement of liquidation. Obviously no notice will have been issued requiring a return for that period.

In such cases HMRC will only normally insist on a full online Company Tax Return - and object to the striking off until they receive it - where there are reasonable grounds for considering that there is a risk of tax loss, if they do not have the opportunity to review a full Company Tax Return.

Where HMRC doesn't think there is a material risk of loss of tax, they will seek to agree the tax liability of the company for the last outstanding accounting period, as well as for the stub period, on the basis of management accounts or similar financial statements and tax calculations based on them, if the company asks HMRC to do so.

**Please note:** the information delivered as a basis for settling the tax affairs of the company in order to permit striking off is **not** a Company Tax Return. So HMRC can't enquire into it. Neither is the online return filing service designed for such cases. In practice, if a company does file such documentation using the online filing service and the information processes successfully, HMRC will normally accept the position but it will remain the case that no Company Tax Return has been filed.

HMRC will also accept the relevant information on paper or by other agreed means provided it meets their needs.

#### **Example:**

Frugal Ltd wants to wind up as quickly and cheaply as possible.

- the company's normal accounting date is 31 December
- it approaches HMRC in May 2012 asking whether we will agree to the company being struck off on 30 September 2012

At that point:

- the company's return for its last normal accounting period to 31 December 2011 isn't yet due (notice issued January 2012, statutory filing date 31 December 2012)
- there will be a stub period from 1 January 2012 to 30 September 2012 for which no CT603 notice to deliver a return has been issued

HMRC:

- reviews the request and is satisfied that there is no material risk of tax loss requiring sight of full Company Tax Returns
- agrees to settle the tax liability of the company for the last outstanding accounting period, as well as for the stub period, on the basis of tax calculations based on management accounts, which the company provides on paper by post
- processes the relevant tax figures as a basis for settling the tax position

If in practice the striking off is delayed and does not take effect until after the filing date for the last normal accounting period, HMRC will only object to the striking off and require a company tax return if there are material tax risks.

#### **Where the return for the last normal accounting period will be due before the likely striking off date**

The company must comply with the requirements of the notice and deliver a full online Company Tax Return for that period, including the Companies Act individual accounts and tax computations both tagged in XBRL. If it fails to do so, it incurs the normal penalties for non-filing. HMRC will maintain that line in relation to informal striking off cases. However, there are particular considerations in relation to MVLs.

Once the liquidation commences, liquidators are under no statutory requirement to prepare full Companies Act accounts for these periods.

The Companies Act does not remove the obligation on the company to prepare company individual accounts under S394, but in practice that requirement is not enforced. For tax purposes, the IP becomes the proper officer of the company and the only person through whom the company can act under the Taxes Acts.

So if the statutory accounts have not been prepared before commencement of the liquidation, the IP is unable to comply in full with the notice as they will not be able to deliver the accounts element of the return. It follows that the computations required by the notice cannot be produced either, as the starting point for them would be a set of accounts which does not exist. Consequently, neither of the two elements of the return which are normally required to be delivered in iXBRL format will be available.

That does not remove the obligation to file online. However, Regulation 3(8) requires HMRC to accept that the filing requirement has been complied with if contraventions or failures to comply with the required form do not undermine the purpose of universal online filing and are necessary in order to deliver the return by the filing date.

So where it is impossible for an IP to deliver normal accounts and computations, HMRC can accept something which falls short of that requirement of the notice.

- The IP must deliver an online return.
- If they do not have appropriate commercial software, they should normally be able to use the free HMRC online filing software available on the HMRC website.
- They will need to complete the relevant boxes of the CT600 return form element. But instead of using the accounts and computations templates in the product, they should tick the box saying there are no accounts and computations attached, and attach one or more PDF documents providing the relevant draft accounts or financial reports and a calculation of any Corporation Tax payable, showing the derivation of the self-assessment in the CT600 from the financial statements provided.

There may be some cases where the structure of the CT600 element of the HMRC free product is not well tailored to the specific needs of a case. HMRC will normally be able to be flexible about that, provided the tax payable is correct.

Such a return will process through the online filing service. It is a satisfactory Company Tax Return and can be enquired into. HMRC will accept it as discharging the filing obligation, subject to risk assessment of the tax charge and enquiry if appropriate.

### **Dealing with outstanding earlier periods**

The requirement to file online should be met wherever HMRC requires a full Company Tax Return. HMRC will expect full online XBRL-tagged Company Tax Returns in relation to normal accounting periods for which the filing date has passed.

So if there are accounting periods for which the Company Tax Return is outstanding and the filing date has passed at the time that the striking off is proposed or the MVL commences, there are no grounds for accepting anything less than a full online Company Tax Return as discharging the filing obligation.

In the case of an MVL, the IP may not be able to supply a full Company Tax Return for such a period depending upon what accounts preparation work has been done and the situation may be beyond their control. HMRC will still make the appropriate tax determinations for such periods and apply the relevant penalties for non-filing. These should be paid by the liquidator as debts to be discharged during the liquidation.

It is in the best interests of all parties for the IP to ensure that HMRC has the best available information on which to base such determinations, and that the tax is paid on time to avoid the possibility of tax-related penalties. HMRC will normally expect the IP to be able to provide detailed management accounts and a tax computation based on those accounts. HMRC will review this information critically and apply normal risk assessment considerations to it. If they are satisfied, they will make the determination in accordance with the computations supplied by the IP. If they are not satisfied, they will make a determination the best of their information and belief.

This information is not a Company Tax Return, so it should not be delivered online and the online filing service has not been built to allow its delivery.

HM Revenue & Customs  
June 2011

### 3. Cold comfort for corporates

DAVID JEFFERY warns of the perils of ignoring the relevant factors when calculating small companies relief

#### KEY POINTS

- The extent of the small companies rate and its value.
- Dormant companies can be ignored under CTA 2010, s 26.
- The restrictive conditions of s 26.
- A comparison of SP 5/94 and s 26.
- Some suggestions for the future.

The corporation tax small profits rate (as the small companies rate is now called in CTA 2010) matters. It matters because it is potentially a valuable relief. It matters also because claims to relief are routinely challenged by HMRC and the resulting settlement can be expensive – particularly if there is an opportunity for the inspectors to go back over past years.

Of course, the value of the relief has been eroded by inflation. The lower and upper rate bands have stood at £300,000 and £1,500,000 since the financial year 1994 and the lower and upper rates of tax stand at 20% and 26% for the year 2011.

By the by, in checking the figures for the earlier years I opened *Tolley's Corporation Tax* for 2001/02. It had 789 pages including the index. The 2010/11 edition has 1,950 pages. I'm glad I won't be reading it 20 years from now.

As almost every *Taxation* reader will know, the above rate bands, when applied to a company, are reduced by reference to the number of other associated companies (broadly speaking, companies under common control, including non-resident companies).

A couple of observations are appropriate at this point. First, close investment-holding companies cannot benefit from the small profits rate. Second, an associated company is disregarded if it doesn't carry on any trade or business in the accounting period.

On this latter point of whether an associated company can be disregarded for the purposes of calculating the extent of the entitlement to the small companies rate, I shall refer now to three tax cases which can sometimes be useful to practitioners.

First, in ***Jowett v O'Neill & Brennan Construction Limited* [1998] STC 482 [2]**, a company carrying on no trading activity, but receiving some interest from bank deposits, was held to be 'in a state of suspended animation', and not therefore carrying on any trade or business (see under 'Section 26 conditions' below).

Second, in ***HMRC v Salaried Personal Postal Loans Limited* [2006] STC 1315 [3]**, a company which used to trade had let its trading premises to a tenant. It was held that the company was not carrying on a trade or business.

Third, in a Special Commissioners' case, ***John M Harris (Design Partnership) v Lee* [1997] SSCD 240 [4]**, a company did nothing other than own an unlet property in France for the use of the controlling director and his family, who personally paid the costs of the company and property.

The Commissioner held that the mere acquisition and holding of property did not amount to a trade or business (see below).

#### The dormant company exception

Turning back to the actual taxation of small companies, there has always been a useful HMRC practice which I refer to below as 'the dormant holding company exception' or 'the exception'. I am sure many

readers are aware that if, in simple terms, a holding company doesn't do anything other than sit on top of its group, then it ought not to be counted in as an associated company.

HMRC's view was expressed in *Statement of Practice 5/94*, which has now been enacted as **CTA 2010, s 26 [5]**. Why this enactment is no good thing, I shall explain below.

Actually, if readers turn to s 26, I think they will be more than a little surprised at how very restrictive the legislation is.

Since I hadn't read the statement of practice for some time, I confess to having had a somewhat hazy notion that if a non-trading holding company receives no taxable income (UK dividends have always been non-taxable except in rare circumstances), other than perhaps a few pounds of bank interest, and makes no claim for loss relief, management expenses and the like, then there ought to be no problem in getting the benefit of the dormant holding company exception.

However, s 26 imposes some difficult conditions to be met if the company is to be treated as a 'passive company' and therefore not carrying on business.

In short, the legislation announces a welcome relief from a harsh application of the law, and then imposes conditions which are so unrealistic that few can benefit.

### Section 26 conditions

The above mentioned conditions set out in s 26 are as follows.

1. The company must have no assets other than shares in its subsidiaries. So what about a bank account with a few pounds of cash in it? What if the holding company, having received funds from its shareholders, has not only acquired shares in subsidiaries, but has lent some monies (probably interest free) down to them? What about a 50% share in a joint venture company? Clearly, any assets, other than shares in a subsidiary, disqualifies the company from relief.
2. The company should have no profits other than from franked investment income (i.e. UK dividends carrying a tax credit), so there can be no bank interest (not withstanding the *O'Neill & Brennan* case referred to above) or no interest from an associated concern, and no chargeable gains.
3. The company should have no management expenses and no qualifying charitable donations.
4. All dividends received should be paid out in the year. So, what if the company retains some dividends (perhaps to pay the annual return fee to the Companies Registrar, or a small amount to its long-suffering accountant for maintaining the statutory books and records)? Sorry, no exceptions.
5. Furthermore, neither the dividend, 'nor any asset representing it' of the accounting period, should be treated as an asset, nor any right to receive the dividend in that or any previous accounting period. What this seems to be saying is that if you have a debtor in the holding company's accounts representing an undeclared or unpaid dividend from a subsidiary, then that rules out the exception. I am not sure what the cunning ploy is that this condition has been designed to counter, but it's too subtle for me.

### A common scenario

At this stage it might be helpful to consider a not uncommon situation as set out in **X Limited**. Let us look at some of the questions and problems which may come up in relation to **X Limited**.

#### **X LIMITED**

Andy and Barry are equal shareholders in a close trading company, X Limited.

Barry wishes to exit and Andy is agreeable that he may be bought out over a period of time for £250,000, so Andy forms a

new UK company ('Newco').

Newco acquires all the shares in X Limited for £500,000 by issuing (i) new ordinary shares to Andy and (ii) redeemable loan notes or preference shares to Barry (intending that they be repaid in tranches over a period of years).

First, what about Newco's acquisition of X Limited? Seemingly that in itself does not cause the conditions to be infringed, even though it might be seen as an active transaction.

However, in the above example, Newco will have bought a subsidiary for £500,000. If X Limited were then to pay up a post-acquisition dividend of £100,000 to Newco, it may well be that this dividend is not distributable because X Limited's value will have been reduced by the payment, and there will be an impairment reserve in Newco thereby reducing its distributable reserves. Because the dividend received cannot be paid out, that condition is not met.

Second, and quite apart from the first point, Newco in effect owes Barry £250,000 – it is required to redeem his loan notes or preference shares on the due dates. How can it obtain the funds to do this? Answer: by dividends from X Limited. But these dividends received will of course not then be paid out as dividends, and so the condition is not met.

Third, Andy may have hoped that Newco would carry out a traditional holding company role, as a store of value within the group. It is standard commercial practice in a group to vote up, as a dividend, reserves of subsidiaries to a holding company, and in this way to insulate the growing value within a group from the risks inherent in normal commercial trading. These amounts are sometimes loaned back down.

However, this simple asset protection strategy infringes the distribution condition.

Finally, Newco may later decide to sell X Limited. That will likely crystallise a chargeable capital gain and any claim to the exception would fail. What, though, if the gain were to be exempt under the substantial shareholding exemption (SSE)?

Prima facie, that would not seem to be a problem per se, except that any sale of shares will give rise to an asset (the sale proceeds) and the presence of those assets on Newco's balance sheet will be a problem.

### **A relaxed view?**

The legislation in CTA 2010 displaces *Statement of Practice 5/94*, whose terms were virtually identical; so, you might say, has anything changed? My view is that it has. A statement of practice is just that: a notice setting out how, in practice, HMRC will apply the law.

It is not an extra-statutory concession. A concession is a relaxation of the law by HMRC and its existence indicates that the HMRC is not imposing the letter of the law in some respect or other. A statement of practice implies no concessionary practice.

It is simply a note of how HMRC will give effect to the law.

This means that, in the matter we are considering, HMRC have taken the view that in a particular scenario a holding company is passive. Now, if that is HMRC's view of the legal position in circumstance A, then if circumstance B is close to it, it would be reasonable to suppose that the same conclusion would apply, unless the difference is material in substance or principle.

That is why I think that my experience of HMRC's approach has been more relaxed than the strict terms of the *Statement of Practice 5/94* might indicate. It has never had legal force; it has only ever been a pointer.

Now, of course, the fact that the statement has been enacted in law means that a hard and fast line is inevitable, and the existence of a bank account with a few pounds in it, or a small amount of a dividend retained to meet a minor expense of maintaining the holding company, will cause any claim to fail.

It is of course galling. The purpose of dividing the lower and upper rate bands by the number of associated companies (inclusive of the claimant company) is to prevent abuse by multiplying the number of companies under common control which could otherwise make separate use of the relief.

But if a holding company has no income or gains, and claims no management expenses or losses to carry forward, where can the loss be to the Exchequer?

### **What can be done?**

We often assume that 'artificiality' in tax planning is reprehensible. Regrettably, the stringent conditions attaching to the relief for dormant holding companies mean that artificiality is essential if the relief is to be claimed. What can be done?

First, ensure that all expenditure referable to the holding company (including any annual return fees or accountancy costs) are borne by subsidiaries. Never, ever, claim any relief for the amounts as management expenses of the parent.

Second, if, in our example above, Newco (the holding company) has to redeem loan notes, ensure that the redemption is paid for by a subsidiary.

In Newco's books a liability to Barry (the outgoing shareholder of X Limited, the subsidiary) will then be replaced by a liability owed to the subsidiary.

If Barry holds preference shares instead it would seem preferable that they should not be redeemed as such, but cancelled in return for payment at par under the reduction of capital rules in **Companies Act 2006** [6] (with the actual payment being made on behalf of the parent company by a subsidiary).

A liability on the balance sheet (the redeemable preference shares) will be replaced by another liability now owed to the subsidiary.

For information on capital reductions by special resolutions supported by solvency statements, see my article **Not all bad news!** [7]

Next, ensure that if dividends are paid to the holding company then every penny is forthwith paid through to shareholders. Forget about using the holding company as the group's store of value.

Fourth, bear in mind that s 26 sets out the conditions for the exception to apply. It does not follow that because the exception does not apply then the small profit rate cannot be claimed. Remember the French property case; the mere ownership of an asset which did not produce income did not mean that the company was carrying on business.

Nor did the receipt of interest in the O'Neill & Brennan case. Ask whether a case can be built up for asserting that the holding company was not, on basic principles, carrying on a business in the accounting period, even if the strict conditions for claiming the s 26 exception have not been met.

Fifth, as an alternative, give up on claiming passive status. Go in for income splitting. In our example, Newco had our subsidiary, X Limited, so Newco can receive profits up to £150,000 without moving into the marginal rates. See what can be done by way of shifting the group's trading premises into the holding company, and then paying rents and service charges to it.

Employ directors and employees in the holding company and charge down remuneration costs with an uplift. Pay all reserves into the holding company as dividends, and then loan back at interest. And so on...

Finally, some entrepreneurs have newco-itis: they think of an idea, then form a company. This disease is of course disastrous from the standpoint of the small profits rate. Generally speaking, it is better to start off a new venture in a partnership (or limited liability partnership if you need the assurance of limited liability).

You can always take the new business into a conventional limited company later if you decide to. Remember that an LLP, although it is a body corporate with its own legal personality, is tax-transparent and cannot be counted in as an associated company.

Remember also a simple tax-planning ploy. If, for example, a stand-alone company has annual profits over the £1,500,000 upper-rate band then create an associated company and ensure its profits are one half of the £300,000 lower-rate band.

### **To conclude**

It's a shame that this article has to be written. The purpose of the small profits rate is to reduce the tax burden on smaller companies. The purpose of dividing the upper- and lower-rate bands by reference to the number of associate companies is to prevent abuse by multiplying the number of companies under common control making separate use of the relief.

But if a holding company has no taxable income or gains, and makes no claims to management expenses or other deductions, how can there be a possible loss to the Exchequer? Are there any suggestions for change? Here are some of mine.

Disregard dormant holding companies receiving no taxable profits and claiming no management expenses or other deductible amounts, even if they have assets such as bank accounts or loans to subsidiaries. Lift the requirement that all dividends receivable must be paid to shareholders.

Disregard holding companies receiving amounts of non-trading non-rental income (e.g. bank interest) provided that they pay tax at the full corporation tax rate on such income.

Disregard overseas companies with no base in the UK. Can they realistically be involved in a ploy to abuse the small companies rate for UK resident companies? All this does is to add a tax cost to groups trying to locate abroad. At least allow the first of such non-resident entities to be disregarded.

Disregard associated close investment-holding companies; they are being taxed at the full rate, so where is the avoidance?

A more radical suggestion would be that any company could elect to be treated as non-associated with the claimant company provided that it also agrees to be taxed on the full rate on such profits as it receives.

Above all, there should be political clarity. Is it thought desirable that companies with small profits should pay corporation tax at a lower rate? If so, get rid of onerous restrictions, such as those inflicted on passive holding companies.

If not, then rid us of the hypocrisy of claiming that small companies are being given fiscal incentives, while the small print is intended to impede entirely legitimate claims, and scrap the relief.

***David Jeffery MA(Oxon), MSc, CTA (Fellow) is a consultant operating through his own company. He can be contacted by telephone on 01624 618467 and via email .***

Issue: Vol 168, Issue 4314  
Wed, 27/07/2011

---

**Source URL:** <http://www.taxation.co.uk/taxation/Articles/2011/07/27/27312/cold-comfort-corporates>

#### 4. Practice guide: How to handle purchase of own shares

<http://www.taxjournal.com/tj/articles/practice-guide-how-handle-purchase-own-shares-29152>

Tax Journal. July 21, 2011

A company purchase of own shares (POS) can be a useful planning tool for an owner-managed company.

It can be used to facilitate the exit of a shareholder or to carry out a management buyout; the latter can be particularly efficient if combined with an approved share scheme such as Enterprise Management Incentives (EMI).

Take the situation where there is a successful private company owned by a husband and wife.

They are both in their late fifties and are thinking about an exit strategy.

There are three employees who they believe would be capable of taking the business forward.

The directors could put an EMI plan in place with the intention that each of these employees get, say 10% of the shares in the company.

The employees would pay whatever market value is agreed with HMRC.

When the options are exercised the husband and wife would now have 70% of the company and the management could carry out a management buyout (MBO) by using a POS, subject to the company having sufficient reserves.

The benefits are:

- the repurchase is in effect funded out of future profits;
- the management do not have to personally borrow funds to acquire the shares;
- the existing shareholders do not lock more money into the base cost of their shares; and
- the company can usually get a corporation tax deduction for interest on borrowings to fund the repurchase.

#### **Income treatment**

Generally a POS is treated as a distribution, as defined in CTA 2010 s 1000(1)B:

‘Any ... distribution out of assets of the company in respect of shares in the company except however much (if any) of the distribution:

(a) represents repayment of capital on the shares, or

(b) is (when it is made) equal in amount or value to any new consideration received by the company for the distribution.

For the purposes of this paragraph it does not matter whether the distribution is in cash or not.’

However this does not override the fact that there is a disposal for CGT purposes.

So there are two parts to the disposal for an individual shareholder.

First, there is a capital gains transaction in respect of the shares, the proceeds being the total amount of the consideration received from the company less any amount that is subject to income tax (TCGA 1992

s 37), which will usually be equal to the capital subscribed for the shares including any share premium attaching to the shares.

Second, there is a distribution in respect of any excess which will be taxed as dividend income under ITTOIA 2005 s 383. See Example 1.

### Example 1: income tax treatment

Mike acquired 10,000 £1 shares in Chalfont Ltd in 2000 for £10 per share. In July 2011 the company repurchases 1,000 shares from Mike for £150 per share so he receives £150,000. The tax treatment is as follows:

- Income tax: Distribution £140,000 ((£150,000 less £10,000)
- Capital gains: Proceeds £10,000 less cost £10,000. Net gain £0

Suppose Mike had acquired the shares second hand for £10 per share and the original shareholder had only subscribed £1 per share the tax consequences would be different.

- Income tax: Distribution £149,000 ((£150,000 less £1,000)
- Capital gains: Proceeds £1,000 less cost £10,000. Net loss £9,000

Although this loss has arisen on a connected party transaction this will not be treated as a clogged loss for Mike as there has not been a disposal and an acquisition. The company has cancelled the shares.

### Capital treatment

The basic treatment above is set aside where the POS is carried out by an unquoted trading company and one of the following conditions is met:

- **Condition A:** that the POS is made wholly or mainly for the purposes of benefiting a trade carried on by the company or any of its 75% subsidiaries and that the POS does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is to enable the vendor to participate in the profits of the company without receiving a dividend or the avoidance of tax and the conditions as set out in CTA 2010 ss 1034–1043 are satisfied. HMRC's SP2/82 gives examples of the trade benefit test.
- **Condition B:** that the whole or substantially the whole of the payment is applied in discharging a liability for inheritance tax and it is so applied within two years following the death.

The conditions in CTA 2010 ss 1034–1043 are:

**Residence:** the vendor must be resident and ordinarily resident in the tax year in which the repurchase is made. This test is largely irrelevant now that there is no advance corporation tax (ACT) on dividends.

**Period of ownership:** the shares must have been owned by the vendor throughout the five years ending with the disposal. Where the shares were acquired by the vendor at different times they are treated as being disposed of on a first in first out (FIFO) basis.

If at any time during the five-year period the shares were transferred between spouses or civil partners and they were living together at the date of transfer, the periods of ownership of both spouses or civil partners are aggregated.

Where the vendor has acquired the shares under will or intestacy the period of ownership is aggregated with the deceased or personal representatives and the required period is reduced from five years to three years.

**Reduction of interest as a shareholder:** where shares are held by the vendor after the POS his interest must be substantially reduced. Substantially reduced is a reduction of more than 25%. See Example 2.

## Example 2: capital treatment

Seer Ltd has 1,000 £1 ordinary shares in issue and the shareholders are:

Jen	200 £1 ordinary shares
Sue	450 £1 ordinary shares
Nick	150 £1 ordinary shares
Tom	200 £1 ordinary shares

Nick and Jen are married. The company purchases Jen's shares leaving 800 shares in issue. As Jen and Nick are associates their shareholdings must be looked at together for the purposes of this test. Jen's interest before the POS is 35% (350/1000) and her interest after the POS is 18.75% (150/800). Jen's shareholding is less than 75% of her prior interest so the test has been satisfied.

### Practical tip

Where there are more than two shareholders the process of calculating the correct number of shares to repurchase is very often done by trial and error which can be tedious.

Practitioners can use the formula below to calculate the minimum number of shares to repurchase so the substantial reduction test is met.

(The answer should always be rounded up!)

$$\frac{S \times C}{4C - 3S}$$

$$4C - 3S$$

where

S = the shareholding of the vendor before the repurchase; and

C = the issued share capital before the repurchase.

In Example 2 the formula would have given a minimum of 119 shares to repurchase.

$$\frac{350 \times 1,000}{4,000 - 1,050} = 118.64$$

**Entitlement to profits:** the vendor's entitlement to profits must also be substantially reduced.

The purpose of this test is to prevent a shareholder selling his shares back to the company and continuing to benefit from a disproportionate amount of profits.

It is often assumed that once the nominal value test above is met then this test is also met. This test can be a trap for the unwary.

In applying the test the profits are increased by £100 and if any person is entitled to periodic distributions the profits are also increased by that amount. See Example 3.

### Example 3: entitlement to profits

Jordan Ltd has 100,000 ordinary £1 shares and 5,000 10% preference shares in issue. These shares are held as follows: John has 20,000 £1 ordinary shares and 5,000 preference shares; Fred has 50,000 £1 ordinary shares; and Ken has 30,000 £1 ordinary shares. Whether this test is met depends on the price of the repurchased shares and the level of distributable profits. The intention is for Jordan Ltd to acquire 9,000 shares from John for £15,000. If the distributable profits were £20,000 before the purchase the profits for the purposes of the test would be:

	£
Distributable profits	20,000
Statutory addition	100
Preference dividend	500
	<u>£20,600</u>

John's entitlement prior to the purchase is:

	£
Preference dividend	500
20% of balance of £20,100	4,020
	<u>£4,520</u>

This is 21.94% of the total.

After the purchase the profits available for distribution are £5,100,

John's entitlement is:

	£
Preference dividend	500
12.09% of balance of £5,100	617
	<u>£1,117</u>

This is 19.95% of the total which does not represent a substantial reduction so this test is failed.

**Group conditions:** if the company is part of a group the substantial reduction test must be met in connection with the group as a whole. A group in these circumstances is defined as a 75% group.

**Connection:** following the POS the vendor cannot be connected with the company. Connected for these purposes is an entitlement to more than 30% of the issued ordinary share capital of the company; the loan capital and the issued share capital of the company; or the voting power of the company.

In considering this test the nominal value of the shares and loan capital is used.

This means that if a company has issued share capital of 10,000 £1 ordinary shares, and a shareholder has 1,000 shares and has also made a loan to the company of £20,000, his total interest in the company amounts to 70% of the combined loan capital and issued share capital of the company (21,000/30,000).

If the loan cannot be repaid this situation could be dealt with by issuing further share capital so as to swamp the loan capital.

This of course depends on the company either having sufficient reserves to create further share capital, or on the shareholders being willing to inject some further funds into the company by way of a share subscription.

In the above example, the company would have to issue a further 40,000 £1 ordinary shares, so that the total share capital is £50,000 and the loan capital is £20,000.

CGT treatment is mandatory where the conditions are met.

If CGT treatment is not required the transaction should be structured to ensure that the conditions are not met.

This could include repurchasing the shares in tranches or presenting a repurchase which has as its main purpose the provision of funds to the shareholder.

---

### **Seven potential traps to avoid**

1. The assumption that the vendor wants CGT treatment. Always do the maths. It is more tax efficient for a basic rate taxpayer to have the proceeds taxed as a distribution. Also the vendor may have income tax losses to relieve the tax.
  2. Meeting the substantial reduction test and not meeting the connection test or vice versa.
  3. Loss of entrepreneurs' relief where the director resigns first. Resignation should always be after the repurchase.
  4. Not having a benefit to the trade; this is not the same as a good commercial reason.
  5. Repurchasing the shares in instalments but not getting the sequence of events correct.
  6. Other tax issues may arise if the purchase price does not reflect market value, for example employment related securities.
  7. Do not forget stamp duty at ½%.
- 

### **Relevant cases**

In *Moody v Tyler* ([2000] STC 296) it was found that the purchase was simply a means to facilitate the repayment of a loan made by the company to the individual so CGT treatment was denied.

In *Allum and Another v Marsh* ([2005] STC(SCD) 191) a husband and wife owned almost all the shares in a trading company, with their son having a very small minority interest. The company's premises had development potential.

The main shareholders wished to retire from the business and saw the sale of the property as a means of providing funds for their retirement, but wanted their son to carry on the trade.

The property was sold without the company securing alternative premises and the company purchased all the shares held by the main shareholders, leaving the son as sole shareholder.

The company only managed to secure limited access to premises which were shared with another company and the company's trade reduced substantially.

It was found that these transactions had not benefited the trade in any way so the disposal by the shareholders could not be treated as capital.

### **Clearance and returns**

Advance clearance can be obtained in respect of the transaction.

As regards the various conditions set out in ss 1034–1043 it will be a matter of fact whether these tests are met.

However the practitioner and the clients may want assurances that the benefit to the trade test is met.

Following the POS the company must make a return to HMRC within 60 days giving details of the payment.

**Paula Tallon, Managing Director, Gabelle LLP**

# BUSINESS TAX

## 5. HMRC 2010-11 report and accounts

Published 11 July 2011

Released 08 July 2011

The National Audit Office (NAO) has issued a report on the 2010-11 accounts of HMRC.

In 2010-11 the Department received total revenues of £468.9 billion, £33.1 billion (7.6 per cent) greater than in 2009-10.

The increase in tax revenue from the prior year reflects the improving economic situation, as well as the impact of rate and duty rate changes including: £5.1 billion (2 per cent) rise in Income Tax and National Insurance contributions; £13.2 billion (17 per cent) increase in VAT; and £8.0 billion (21 per cent) increase in Corporation Tax.

At 31 March 2011, the Department was investigating over 2,700 issues with the largest companies, with potential tax at stake of £25.5 billion. The NAO found that the Department had established sound governance arrangements for settling tax disputes and, in a substantial majority of cases, had complied with these. In three of the largest settlements examined, one or both of the Commissioners signing off the settlement had also participated in the negotiations. This reduced the demonstrable assurance to taxpayers and Parliament that the settlements reached were appropriate.

The Department made significant progress during 2010-11 in stabilising the administration of PAYE. By the end of March it had successfully reconciled the vast majority of records available for automated reconciliation for 2008-09 and 2009-10 and processed the associated overpayments or underpayments of tax. It also ensured that over 99 per cent of annual codes for the 2011-12 tax year for issue to taxpayers were dispatched on time.

The full report is available on the NAO website.

## 6. Hold on to 10%

RICHARD HOLME and STEPH PARKER look at practical issues of entrepreneurs' relief

### KEY POINTS

- Transferring shares to spouse.
- Application of the 5% de minimis requirement.
- Entrepreneurs' relief and trusts.
- Advantages of a formal liquidation.
- Timing of entrepreneurs' relief claim.

Entrepreneurs' relief has been with us for just over three years so we now have considerable experience in advising clients on ensuring they are entitled to this valuable relief – and also preventing any pitfalls from occurring.

The stakes are higher than ever, as over a lifetime an individual can make £10 million of gains qualifying for the relief. So if something goes wrong and capital gains tax at 28% is due, rather than 10%, the taxpayer may be faced with an additional £1.8 million tax liability and he may look to the hapless adviser to settle this if timely advice has been absent.

It is therefore essential that tax advisers review, in particular, shareholdings in all client trading companies with a view to maximising entrepreneurs' relief and ensuring that, wherever possible, shareholders not only have at least 5% of the shares and voting rights, but are also officers or employees of the company in question.

In some situations where shares have been transferred to a spouse to mitigate income tax there have been disastrous effects on the capital gains tax position. See **Share transfer**.

### SHARE TRANSFER

Eric is a director and owns one-third of Keech Ltd with the balance held by external shareholders.

He transfers his entire shareholding to his wife Fredrika, so that she can enjoy a lower rate of tax on dividend income. Eric then tells his tax adviser that an offer has been made to sell the whole company for a £3 million gain.

As Fredrika is not an officer or employee of the company, she will have to pay 28% CGT on her £1 million gain, i.e. £280,000 rather than the £100,000 Eric would have paid.

In this scenario, last minute attempts might be made by some advisers to enable entrepreneurs' relief to be claimed by appointing the spouse as a director, officer or employee or transferring the shares back to the other spouse.

However, a one-year ownership period is needed before a qualifying disposal. It could be embarrassing, let alone commercially inopportune, if an appetising exit has to be deferred in consequence, or more risky arrangements (such as cross options or conditional contracts) are entered into with a view to deferring the date of disposal for CGT purposes until entrepreneurs' relief is available.

### What is a trading company?

The tax adviser may also be looking to ensure that shares qualify for business property relief for inheritance tax purposes. This may be the case where perhaps there is doubt as to whether the company is a trading company for CGT purposes, although the definitions for the purposes of IHT and CGT are (subtly) different.

For CGT purposes, 'trading company' is defined in **TCGA 1992, s 165A(3) [2]** as 'a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities'.

This is the same definition used under the previous taper relief regime and gives rise to similar potential difficulties in practice.

It is understood that HMRC will regard any activity as not being 'substantial' if it comprises less than 20% of the company's activities. Therefore attention needs to be paid to aspects such as the level of assets, turnover, profit and number of employees engaged in trading and non-trading activities.

Problem areas may arise, as they did with taper relief, where it is perceived that the company may have cash in excess of its current trading requirements. See **Cash**.

## **CASH**

Alison Ltd trades as a recruitment consultant and, due to high profits, has built up a bank balance of £400,000.

This comprises 35% of gross assets and 25% of net assets, but the directors have minuted to confirm they are retaining this cash for future business purposes.

In this situation, there would be no difficulty in the shareholders claiming entrepreneurs' relief on a disposal. This is because the cash has been generated from trading operations and is being retained for that very purpose; it is not an investment activity.

In the current difficult recessionary climate this could be an especially convincing argument to put forward.

Many trading companies may have sublet premises surplus to requirements or they may be lying vacant. No difficulties should arise because these should not be regarded as non-trading activities in the current economic climate.

It has been suggested by some that an effective means of accessing profits in a trading company is for director-shareholders to take loans from the company. Rather than pay tax on dividends at effective rates of up to 36.1%, the shareholder could take a loan on which the company would need to account for tax at only 25% under **CTA 2010, s 455 [3]**.

Not only is the overall tax burden less, but it is borne by the company and the debt should be deductible for IHT purposes on death.

The question arises, though, as to whether the loan is actually an aspect of the company's trading operations or whether it is to be regarded as an investment activity.

The cautious view would be to avoid charging interest on the loan account (although this gives rise to an income tax charge under **ITEPA 2003, s 175 [4]**) so that this asset has less prospect of being characterised as an income-bearing investment and thus prejudicing the company's status for entrepreneurs' relief purposes.

## **Watching that 5% threshold**

In limited cases there may be a very large number of individuals involved in a business, each of whom owns perhaps less than 5% of the equity in the new business. There is no 5% de minimis for partnership interests so it might have been preferable for them to invest through a limited liability partnership.

Otherwise it has been suggested that the use of an intermediate holding company could be of some use in enabling minority shareholders to obtain the benefits of entrepreneurs' relief, using the joint venture provisions (**s 165A(14) [5]**).

See **5% threshold** [6].

Another area of difficulty on the critical 5% threshold is where the exercise of share options on an exit causes the percentages held by longer standing shareholders to dip at the last minute with the result that entrepreneurs' relief is not available.

If this situation can be predicted, the share option arrangements can be replaced by cash compensation to prevent a costly loss of the relief for others.

### **Directors, officers, employees?**

There may in practice be a reluctance to appoint certain family member shareholders as officers or employees and it is generally regarded that a director or officer does not need to be paid or even perform any significant duties, let alone work full-time.

To give substance to any employment where entrepreneurs' relief is in point, it is important to show that any employees are paid in order to underpin this status.

Sometimes with an overseas company it may be the case that a significant UK-resident shareholder is not a director so as to reduce any prospects of the company being regarded by HMRC as centrally managed and controlled in the UK, and hence UK-tax resident.

In that scenario, it will be preferred if the individual is, say, company secretary, as this post is an office and, all other things being equal, will allow entrepreneurs' relief to be claimed by the shareholder on a disposal of his shares.

### **Trust aspects and concerns**

Difficulty may arise with trust shareholdings, as many families have chosen to retain flexibility by using discretionary trusts to hold shareholdings. They are also used for IHT reasons, on the first death in a married couple or civil partnership, so that the business or agricultural property is not within the estate of the surviving spouse.

Historically, settlor-interested discretionary trusts may survive from the days of the now defunct taper relief where they served to maximise availability. Their CGT status needs urgent review.

Discretionary trusts (and estates of deceased persons) will never qualify for entrepreneurs' relief and there are complex provisions for life interest trusts in that they must, for example, have a life tenant who is an officer or employee of the company concerned and who must have at least 5% of the shares in his own right.

Consideration needs to be given to changing the status of discretionary trusts to life interest trusts (perhaps on a revocable basis to maintain flexibility for the family) to maximise entrepreneurs' relief with the incidental benefit of reducing the overall tax rate on dividends received and then distributed. See **Trusts**.

### **TRUSTS**

The Emily Discretionary Trust owns 20% of Ukulele Ltd and disposal of that company could take place in the next two to three years. The trust would pay CGT at 28%.

However, by converting to a life interest trust at least a year before disposal, and by transferring at least 5% of the shares to Tom, the life tenant, who is a director of the company, not

only can the trust claim entrepreneurs' relief but Tom can as well.

Consideration must be given to the life tenant's other business interests, though, as the trust's entrepreneurs' relief claim will use Tom's lifetime limit of £10 million; it does not have a £10 million allowance of its own.

Tom may not be inclined to agree to the joint claim required under **TCGA 1992, s 169M(2)(a) [7]** if he does not benefit fully from the trust's capital.

An offshore trust can make tax-free gains provided settled by a non dom. If a capital payment is made to a UK-resident beneficiary, a CGT liability may arise, but entrepreneurs' relief should be available in principle. If the capital payment is made outside the normal time limits in which a claim for entrepreneurs' relief must be made under **s 169M(3) [8]**, it is understood that HMRC may well allow the relief in this situation.

The relevant point is that the time limit for the claim relates to the original disposal rather than to the capital payment which might take place several years later.

### **Winding up companies**

Many clients wish to use lower corporate tax rates on profits through the use of limited companies which might undertake, for example, a property development or act as a corporate partner.

In some such cases there may be perceived benefits in profits being retained with a view to winding up the company in a number of years with shareholders claiming entrepreneurs' relief, on the basis that it is better to pay 10% CGT than suffer 36.1% tax on dividends now.

It is understood that to avoid the transactions in securities provisions of **ITA 2007, s 687 [9]** and enjoy CGT treatment, it would be prudent for the company to be wound up through a formal liquidation (see HMRC's *Company Taxation Manual* CTM 36850).

There may still be difficulties with the trading status of such a company if substantial cash balances have been generated and thus entrepreneurs' relief may be unavailable.

To minimise the prospects of an HMRC challenge, consideration might be given to the company concerned becoming engaged in other trading operations through involvement in other qualifying trades, such as film partnerships or holiday lets, so as to use the cash.

### **Holiday lets and mixed-use assets**

The disposal of qualifying furnished holiday lets will qualify for entrepreneurs' relief provided certain conditions are satisfied. See **Rental properties**. It should be noted that, in all probability, they need only to be satisfied in a one-year period prior to the disposal although the matter is not entirely clear.

### **RENTAL PROPERTIES**

Debbie runs a chain of rental properties and has done so for many years.

In June 2010, she starts to let the properties on a holiday-let basis and when she sells in August 2012 she is able to claim entrepreneurs' relief as in the 12-month qualifying period she is carrying on a qualifying business.

Generally for disposals of business assets or businesses, there does not appear to be any apportionment of the period of ownership between qualifying and non-qualifying purposes as is required for associated

disposals (**TCGA 1992, s 169P(4)(b) [10]**). The use of this provision could be helpful if, in the latter stages of the ownership of some valuable land, a qualifying trade has been carried on.

A holiday let may also have been used as a family residence and hence in addition to entrepreneurs' relief, an election under **TCGA 1992, s 222(5) [11]** may reduce any CGT due on disposal, particularly through the application of **s 223(2)(a) [12]**.

### Claiming and disclaiming

The entrepreneurs' relief provisions have been little changed since they were introduced, but we have seen generous increases in amounts of gains qualifying for the relief from the original £1 million to £5 million and now £10 million. It should be remembered that it is not mandatory to claim the relief. See **When to claim**.

### WHEN TO CLAIM

Diana sells Dove Ltd for a £1 million gain in February 2010 and could claim entrepreneurs' relief. She then sells Badger Ltd for a £10 million gain in November 2010.

She chooses to claim the relief against the gain made in November that would otherwise be charged at 28%, and to pay 18% CGT on the February 2010 gain.

In this situation, **s 169M [7]** makes it clear that relief must be claimed but can then be disclaimed within the appropriate time limit, which is 22 months after the end of the tax year of the qualifying business disposal.

### Paying 'up front'

There have been important changes in the availability of entrepreneurs' relief where shares in a personal company are sold for shares or securities in a predator which is not the vendor's personal company.

This means that it may not be possible to claim the relief when the paper proceeds are disposed of. There may be situations where it is appropriate to use the provisions of s 169Q(2) to pay CGT 'up front' even on such 'paper' consideration. See **Advance payment**.

### ADVANCED PAYMENT

Nicola is selling King Ltd in August 2011 for £1 million cash, two million shares in a fully listed company and £2 million loan notes, with the entire proceeds representing a gain.

**TCGA 1992, s 135 [13]** could allow the gain on the shares and loan notes to be deferred until they are disposed of, but 28% CGT would be payable on their ultimate disposal.

Although it would still be prudent to go for clearance under **s 138 [14]**, Nicola would probably be well advised to elect under **s 169Q(2) [15]** to pay the CGT on the entire consideration in 2011/12 at 10%.

Sometimes an individual cannot claim entrepreneurs' relief and is faced with a 28% CGT charge. The CGT may be only paid at 18% where an individual has a low taxable income, below around £42,475.

Such individuals could consider transferring shares to spouses and children just before a sale to take advantage of their CGT annual exemptions and the lower-rate bands for children. It is key in this situation

to ensure that these are genuine gifts and any proceeds are solely for the benefit of the transferee family members.

Sometimes there might be unexpected good news in that entrepreneurs' relief may be available, in seemingly unlikely circumstances, as shown in **Good outcome**.

### **GOOD OUTCOME**

You are approached in June 2011 by shareholders in Charlie Ltd, an investment company holding £10 million cash, owned by Felix and Florence.

On making enquiries, you ascertain that Charlie Ltd traded until September 2008 and the cash arose from the sale of its trade.

Entrepreneurs' relief can be claimed by Felix and Florence provided they are still officers or employees and the company is wound up within the three-year time limit prescribed by s 169I(7) [16].

Last, it is important to ensure that any premises (or other chargeable assets) qualify for entrepreneurs' relief on a disposal, if held outside the business. It is well known that the payment of a rent since April 2008 will restrict relief and it is important that the disposal is associated with the vendor's withdrawal from the business.

If one of such premises is being sold, but the associated business (presently conducted as a partnership) is being continued, entrepreneurs' relief would be available if the partners' 'withdrawal from the business' was triggered by incorporating the business, so their direct involvement ceased.

In other cases, the business premises are held within the partnership business and it is important that this is evidenced through appropriate legal documentation and accounting treatment, which may indicate that different partners have differing capital entitlements to partnership assets.

Sole traders cannot claim entrepreneurs' relief for associated disposals, so assets used in the business should be included as business assets in the accounts and documented as such.

Similar considerations may apply to a partnership with one equity and a number of salaried partners.

***Richard Holme and Steph Parker are with Creaseys LLP, Tunbridge Wells. Richard can be contacted on 01892 546546 and via email [17].***

Issue: Vol 168, Issue 4312 [18]

## 7. Best of both worlds

When considering the available incentives for investors in new businesses, PAUL HOWARD and MARTIN MANN explain that EIS and EMI can co-exist happily

### KEY POINTS

- EIS and EMI: a brief overview of their purpose.
- EIS rules of ITA 2007, Part 5 and EMI regulations in ITEPA 2003, Part 7 Ch 9 and Sch 5.
- Where the schemes would not work and where relief could be withdrawn.
- Which companies are eligible for the reliefs?
- Connection tests under ITA 2007, s 163 and s 170.
- The interaction with entrepreneurs' relief.
- Don't be caught out by disqualifying events.

Obtaining finance and attracting the best employees is challenging for any new business. A company can get the best of both worlds in the form of the enterprise investment scheme (EIS) and enterprise management incentives (EMI) where tax incentives can make all the difference for investors, employees and the company (in the form of a corporation tax deduction for shares issued under EMI).

The EIS provisions in [ITA 2007, Part 5](#) [1] outline how investors can claim income tax relief at a rate of 30% on the amount invested, with a capital gains tax exemption available on the eventual sale of the shares. Capital gains tax deferral relief is also available if the investors wish to shelter gains made on other assets.

Further changes will be introduced in FA 2012, subject to state aid approval, to include increasing the eligible investment from £2 million to £10 million to stimulate and boost the popularity of EIS as a means of plugging the funding gap being experienced by such businesses.

Equally, start-up companies often promise employees equity in the business and one way to achieve this is to offer them options under an EMI scheme. EMI ([ITEPA 2003, Part 7 \[2\]](#) Ch 9 and Sch 5) is still the most efficient and flexible scheme for small and medium-sized enterprises (SMEs).

Under the scheme, the company can use different classes of shares such as growth shares or shares which only have value on an exit.

The advantage for start-up companies is that, generally, the shares have a low value, so the amount payable on exercise or the potential income tax charge, where the options are exercised at less than market value at grant, will be low.

Furthermore, HMRC will agree values prior to the grant of the option making it easier to plan for any tax charges. The overriding benefit of EMI is that the growth in the value of the shares is typically charged to capital gains tax.

It is sometimes difficult to balance the needs for investment with the desire to attract and retain key employees. There are a number of issues that commonly arise which could affect EIS investors or EMI option holders or both, and it is important to consider these at the outset to ensure that founders, investors, or employees are not disappointed.

Also there are the pitfalls, highlighted in [EIS/EMI summary](#) [3], which can lead to a loss of EMI and EIS relief.

As is common with valuable reliefs and approved schemes, eligibility is centred around strict conditions which have to be met to secure the relief.

A detailed analysis of the qualifying rules and anti-avoidance provisions is beyond the scope of this article; instead, this article will cover the common issues which can create tensions for EIS investors and EMI option holders and, where appropriate, offers some ideas on how to resolve these difficulties.

## Issues common to both

To be eligible for both EIS and EMI, the shares/options must be in a qualifying company carrying on a qualifying trade.

A qualifying company is one which is not under the control of another company and where any subsidiaries held must meet set criteria to become qualifying subsidiaries.

A qualifying subsidiary will be a subsidiary in which more than 50% of its share capital is held by the company issuing shares or options. Rules are more stringent where the company holds a property managing subsidiary.

The founders of the business may want investors and employees to take shares in a subsidiary, perhaps because the holding company has a number of subsidiaries or other assets that the founders would like to ring-fence with different investors/employees.

Neither EIS nor EMI would work in this situation. For EMI, a new class of shares could be created in the holding company but with rights attributable to the value of the subsidiary. However, this would not work for EIS.

Problems can arise where ordinary shares are issued to EIS investors, and options are granted to employees where restrictions are attached to the shares subject to the options.

In this situation the EIS shares may be regarded as having a preference if the EMI options are granted within three years of the issue of the EIS shares. This is illustrated by **ABC Limited**.

### ABC LIMITED

ABC Limited was formed in March 2009, issuing 6,000 £1 ordinary shares to each of five EIS investors. The company started to trade in May 2009.

In May 2011, ABC Limited granted EMI options to two employees, entitling them to subscribe for a total of 1,000 £1 A ordinary shares.

In the event of a winding-up, the A ordinary shareholders will receive capital only after the ordinary shareholders have been repaid their capital.

Although there has been no change in the rights attaching to the ordinary shares issued under EIS, the EIS shares now have a preferential right to assets on a winding-up.

As this event is within the relevant period (starting with the issue of the shares and ending three years after the company started to trade) EIS relief will be withdrawn (**ITA 2007, s 234(1) [4]**).

Practitioners will be familiar with the list of excluded activities shown at **ITA 2007, s 192 [5]** and mirrored at **ITEPA 2003, Sch 5 para 16 [6]** which, if carried on wholly or to a substantial part by the company or group, would prevent the use of EIS and EMI.

Although there is no statutory definition of 'substantial', HMRC guidance on EMI and the *Venture Capital Manual* at VCM50470 suggest that 'substantial part' is decided in the light of all relevant circumstances.

However, in many cases where the activities amount to less than 20% of the whole (normally measured in terms of turnover and capital employed), they should not be regarded as forming a substantial part.

Where there is a mix of qualifying and excluded activities it can be difficult to ascertain whether the company would qualify and other factors such as time spent by officers of the company should be taken into account.

EMI options cannot be granted to employees who have a material interest in the share capital or assets of the company. A 'material interest' for these purposes means having more than 30% of the ordinary share capital or more than 30% of assets available for distribution on a winding-up of the company.

Contrary to the rules for EIS, an EMI option holder will not be disqualified where options are granted which on exercise take the individual's shareholding beyond 30%. See **XYZ Limited**.

### **XYZ LIMITED**

A director holds 29% of the share capital of a company, XYZ Limited. The company could grant EMI options over 22% of its shares which, when exercised, would give the director control of the company.

This means that subject to falling within the £120,000 limit an EMI could be used to facilitate a management buyout.

### **Connection tests**

There are similar connection tests for EIS income tax relief purposes (although there are no parallel restrictions for EIS deferral relief), that apply in the period beginning two years before the shares are issued and, generally, three years after the issue of shares (**ITA 2007, s 163 [7]**).

Connection is measured not only in terms of percentage shareholding and holding loan capital, but also in terms of whether the individual is an employee or director of the company.

**ITA 2007, s 170 [8]** states that an individual is connected with the issuing company if the individual 'directly or indirectly possesses or is entitled to acquire more than 30% of:

- the ordinary share capital of the company or any subsidiary of the company...;
- the loan capital and issued share capital of the company...; or
- the voting power in the company...'

The operation of these provisions where a shareholder also has loan capital in the company was considered by the Upper-tier Tribunal in the case of *HMRC v Taylor & Haimendorf* [2010] UKUT 417 (TCC), which, after the First-tier Tribunal taking a contrary view, confirmed the general understanding that the total nominal share capital and loan capital are aggregated to establish the percentage shareholdings in the company.

An individual is connected with the company if he is an employee or director of the company at any time during the period set out in s 163.

However, there is a relaxation for directors if the business angel conditions can be met.

The example of **B Limited** shows that if an individual becomes a director of the company with no entitlement to be paid and subsequently subscribes for shares in the company, he can obtain EIS income tax relief even if he becomes entitled to remuneration after the issue of the shares.

## **B LIMITED**

B Limited was formed by two individuals in June 2010, subscribing for 100,000 £1 ordinary shares each. As they each have more than 30% of the share capital of the company they are not able to claim EIS income tax relief. T

hey would, however, be able to claim EIS deferral relief if they make gains on any other assets in the period June 2009 to June 2013.

Mr Y, who has known the shareholders for some time, is appointed as director of the company in October 2010, as he has expertise relevant to the company's trade.

In March 2011, he subscribes for 30,000 £1 ordinary shares, hoping to get EIS income tax relief.

For this example, we will assume that all conditions will be met, but will concentrate on the connection tests. Mr Y does not have more than 30% of the share capital of the company, so satisfies that leg of the test.

The crucial question is whether he is entitled to remuneration for the period October 2010 when he became a director to March 2011 when he acquired his shares (s 169(a)(i)).

So long as he is not entitled to remuneration for the period before March 2011 he should be able to claim EIS income tax relief. However, if he has an entitlement to remuneration for that period, even if it is only paid subsequently, he would not be entitled to relief.

Even better, once he is locked into the business angel provisions, he can subscribe for further shares within three years of the previous issue of qualifying shares and obtain relief on those further shares.

As Mr Y is a director of the company, so long as he is sufficiently full time the company could grant him options under EMI.

Conversely, an employee of the company would not be able to subscribe for shares and claim EIS income tax relief.

### **Conflicts of interest**

There is a mismatch in relation to the size of company eligible for EIS and EMI. A qualifying company for EMI purposes is one where the gross assets do not exceed £30 million and the total number of employees is less than 250.

For EIS purposes, the gross asset test is currently £7 million immediately before investment and £8 million thereafter although this is due to increase in 2012 to £15 million. The employee count for EIS is currently limited to fewer than 50 (increasing to 250 in 2012).

Employees are granted EMI options over shares, with a usual exercise price of market value at the date of grant. EIS is aimed at investors, with the aim of raising capital, so the company is likely to expect a higher price for the shares.

Where similar percentages of shares have been issued under EIS, the exercise price for any subsequent EMI shares can be influenced by the price paid for shares by investors. There is a conflict where the company wants the EIS price as high as possible and the EMI option price as low as possible. See **C Limited**.

## **C LIMITED**

C Limited is issuing 1,000 £1 ordinary shares to Miss X at a premium of £20 a share in respect of which she is claiming EIS relief. This represents a 5% interest in the company.

At the same time, the directors want to grant EMI options to two employees over 5% of the shares each. For EMI purposes HMRC are unlikely to accept a value of less than the EIS value.

Compare this situation to where the majority shareholder is using EIS to defer gains; for example where an individual has invested £350,000 for a 70% interest in C Limited, HMRC are likely to accept a much lower value for EMI options granted to employees over small minority interests in the company.

Where the company has just started trading HMRC will often accept a nominal value for the EMI shares.

## **Disqualifying events**

A disqualifying event which occurs during the period in which EMI options are held will mean that, unless the options are exercised within 40 days, the tax advantages are lost. The following are disqualifying events:

- Loss of the company's independence.
- The company no longer meets the trading activities requirement.
- The employee is no longer eligible.
- Changes to the terms of the option.
- Alteration to the share capital of the company.
- A conversion of shares.
- Grant of company share option plan options that takes the option holder over the £120,000 limit.

Some of the disqualifying events for EMI overlap with disqualifying events for EIS purposes.

However, the period during which such events can bite for EIS is much longer, extending more than three years after the issue of shares. If there is a disqualifying event for EIS, income tax relief is withdrawn and, as a result, the capital gains tax exemption will also be lost. The principal disqualifying events resulting in a withdrawal or reduction in EIS relief are:

- A disposal of shares.
- A receipt of value by the investor.
- Where the company ceases to carry on a qualifying trade.
- Where the investor becomes connected with the company.
- Where the company fails to spend all the money raised from the issue of shares within two years.

## **Entrepreneurs' relief**

Entrepreneurs' relief is an issue for employees obtaining shares under EMI, with two issues in particular causing concern.

First, shares must be held for at least a year, which runs counter to the usual arrangement whereby EMI options are usually exercised shortly before a sale of the company shares. The extension of the period of

ownership to cover the period options are held that applied for taper relief purposes does not apply to entrepreneurs' relief.

Second, entrepreneurs' relief applies only where the individual holds more than 5% of the shares of the company. Usually EMI options are granted over very small shareholdings, so even if the options are exercised more than a year before the sale relief would still not be available.

Entrepreneurs' relief is not likely to be relevant to individuals who have claimed EIS relief, so long as the shares are held for at least three years, as they would be exempt from capital gains tax.

However, if the shares are sold within one and three years of acquisition entrepreneurs' relief would be available so long as the requirements have been met.

EIS investors are only likely to get entrepreneurs' relief where the individual qualifies under the business angel provisions as the seller has to be an officer or employee of the company.

It is important to plan for EIS and EMI. Problems often arise where individuals have funded a start up situation by making informal loans to a company, or perhaps paying expenses on behalf of the company and only later deciding to capitalise those amounts into share capital. EIS relief will not be available because no new money is raised from the issue of shares.

### **Can EIS and EMI coexist happily?**

While there are some conflicts, the points to watch are as follows.

If a company has raised money under EIS, and investors have, perhaps, paid a premium for their shares, it may be difficult to support a lower exercise price for EMI share options subsequently issued to employees.

Conversely, if EMI options are issued first, and investors are then identified, there may be less of a valuation issue as investors are subscribing for shares in a company which already has an infrastructure in terms of workforce, so that it would be reasonable that the value of the company had increased.

Where a company has raised money under EIS it does not want to prejudice relief for those shareholders by issuing shares to employees under EMI options which have restrictions attaching to them such that the EIS shareholders own shares to which a preference applies.

There may be some tension between the two groups of stakeholders in terms of the reliefs available to them, particularly the capital gains tax exemption that is available to EIS investors whereas employees are likely to have a capital gains tax liability of 28% on the basis either that they will not have held the shares for at least a year or because the company is not their personal company.

However, if a company were able to use both reliefs their entire share capital could be raised in a tax efficient way that incentivises both investors and employees.

As the differing requirements and expectations are addressed, the company can get the best of both worlds: committed investors and motivated employees.

***Paul Howard and Martin Mann are directors at Gabelle LLP, which provides tax support to accountants, and can be contacted on 020 7182 4034 and via email.***

Issue: Vol 168, Issue 4312

## 8. You're trading!

MARK MCLAUGHLIN looks at trading activities and their implications

### KEY POINTS

- Badges of trade are only a guide.
- Transactions in shares and securities.
- Property can be investment or trading stock.
- Difference between a trade and a venture.
- Cases stand on the facts.

The 2012 London Olympics will provide an excellent opportunity for enterprising individuals to apply their entrepreneurial skills to making some money (see ***Olympic windfall***). The Olympics will no doubt be the catalyst for many individuals with aspirations of appearing on *The Apprentice* to engage in activities which they hope would win Lord Sugar's approval.

### ***Olympic windfall***

Arthur lives near one of the 2012 Olympic Games venues. He owns a small plot of land next to his house. Arthur has the idea of offering a car valeting service for the duration of the Olympics, whereby customers can drop off their car to attend the event, and have the car valeted in their absence. If the operation is successful (as Arthur predicts) he will probably extend his valeting service to future events at the venue after the Olympics. Arthur's profits will be taxable as trading income.

The question of what constitutes a trading activity for tax purposes is far from new, however. A lack of legislative guidance has resulted in extensive case law on the subject over the years. Two recent tribunal cases on the subject are highlighted later in this article.

### Identifying a trade

'Trade' is defined as including 'any venture in the nature of trade' (ITA 2007, s 989). And that's it. There is no further statutory guidance for income tax purposes. The previous definition of trade (in TA 1988, s 832) was that 'Trade includes every trade, manufacture, adventure or concern in the nature of trade'.

The term 'adventure in the nature of trade' dates back at least to the Income Tax Act 1853. The term 'adventure' was changed to 'venture' during the Tax Law Rewrite Project as a modernisation measure, but was intended to have exactly the same meaning.

Many *Taxation* readers will be familiar with the 'badges of trade'. These were identified by the Royal Commission for the Taxation of Profits and Income in 1955, using previous case law about what constitutes a trade.

Subsequently, in *Marson v Morton* [1986] STC 463, a total of nine badges were identified. As mentioned, there is also a large body of case law on what amounts to trading. A lack of space prevents discussion of the badges and cases. However, detailed commentary can be found in *Simon's Taxes* (at division B1.403).

In addition, there is an HMRC summary of the badges of trade in the *Business Income Manual* at [BIM20205](#) [1], together with HMRC's interpretation of those badges and relevant case law in subsequent paragraphs.

In the recent case of *Azam* (TC928), the First-tier Tribunal commented that the badges of trade '... must be approached with caution', and highlighted two important authorities dealing with the application of the badges of trade.

In *Marson v Morton*, it was pointed out that the badges 'are in no sense a comprehensive list of all relevant matters, nor is any one of them so far as I can see decisive in all cases. The most they can do is provide common sense guidance to the conclusion which is appropriate'.

In *Salt v Chamberlain* [1979] STC 750, Oliver J said:

'I doubt whether the question whether in any given case a person is or is not carrying on a trade is capable of solution by the application of a logical progression of propositions culled from decided cases. The question is, I think, one of overall impression.'

Thus the badges of trade should not be used as a definitive checklist.

Not surprisingly, in the majority of previous cases on whether the taxpayer's profits were derived from trading activities, the taxpayer sought to argue that there was no trade or adventure in the nature of a trade.

It might be thought that these harsh economic times would result in more taxpayers than before arguing that they are trading, in order to claim income tax relief for their losses.

However, loss relief claims made by individuals and companies on the basis of trading are nothing new; see for example *Salt v Chamberlain*, and *Lewis Emanuel & Son Ltd v White* 42 TC 369. HMRC guidance advocates a consistent approach, whether the transactions are profit or loss making ([BIM20090](#) [2]).

### **Shares and securities**

In *Manzur* (TC830) the taxpayer, a retired surgeon, invested in stocks and shares. His transactions resulted in losses, for which claims were made to offset them against general income. HMRC refused the claims, and the taxpayer appealed.

The tribunal held that the activities undertaken by the taxpayer amounted to investment rather than trading activities, and dismissed his appeal.

In reaching that decision, the tribunal recognised that there is no definitive checklist for determining whether an individual is trading or not. Their overall impression was that the transactions were more in the nature of managing an investment portfolio.

The tribunal noted (from the *Lewis Emanuel* case) that an individual speculating on price movement in shares without intending to hold the shares even as a short-term investment was analogous to gambling, and fell short of trading.

The tribunal considered that the characteristics of share trading by established business were such that 'it is easier to classify the dealings of a company as trading than those of an individual', and added 'share dealing by an individual is more likely to give rise to a capital gains tax charge'.

The tribunal's decision in *Manzur* accords with HMRC's stated approach, which is that transactions in shares and securities (or futures, options or other derivative contracts) are not generally trading transactions ([BIM65701](#) [3]).

HMRC consider that an established share trader will typically have customers, move high volumes of shares very quickly, limit exposure to market movements and have strict rules on risk.

However, it should be remembered that HMRC guidance does not carry the force of law, and that First-tier Tribunal decisions such as *Manzur* do not create a binding precedent.

### **Land**

In *Azam*, the taxpayer's returns also included claims to offset trading losses against general income. HMRC enquired into the returns, and concluded that the taxpayer's activities amounted to UK property rental, not trading as a property dealer or developer.

The taxpayer had bought properties (11 in total) since 2002, but sold none of them. She claimed that the properties were purchased with the intention of reselling them at a profit within a short period, but that

due to a downturn in the property market she was unable to sell any, except at a loss. The properties were therefore rented out on short-term leases until market conditions improved.

The tribunal found that the burden of proof was on the taxpayer to displace the figures in HMRC's closure notice. It applied the badges of trade to the evidence, and accepted as a matter of law that trading stock does not become an investment because adverse market conditions prevent it from being sold for want of purchasers.

However, the tribunal was not satisfied overall that the taxpayer was engaged in a property trade, and dismissed her appeal.

An asset such as a property is capable of being an investment or trading stock. The correct treatment is a question of fact, which may ultimately be for the tribunal or courts to decide.

The taxpayer in *Azam* contended that there had always been an intention to trade. Unfortunately, there was an apparent lack of evidence to support that argument, which resulted in the tribunal making certain findings on a balance of probabilities.

Whereas company owners may be able to produce minutes of meetings to support an intention to trade (or not), the burden of proof is arguably more difficult for individuals.

However, HMRC describe the approach they will take in practice when considering whether a land transaction constitutes trading at [BIM60015](#) [4], which is repeated for other transactions at [BIM20080](#) [5].

This includes HMRC holding a meeting with the taxpayer to establish his intentions at the moment of acquisition.

### **Prove it**

Whether someone is trying to establish that his activities are trading or investment, keeping supporting evidence is very important. In *Edwards v Bairstow and Another* 36 TC 207, the taxpayers entered into a transaction to buy and sell spinning plant.

The General Commissioners determined that the transaction was not an adventure in the nature of a trade.

On appeal, the High Court and Court of Appeal held that the determination was purely a question of fact, and it was not open for the courts to interfere with it, unless the commissioners had 'acted without any evidence, or on a view of the facts which could not reasonably be entertained'.

Unfortunately for the taxpayers, the House of Lords allowed HMRC's appeal, as the commissioners' decision had originally been on the ground that the transaction was an 'isolated case'. The House of Lords recognised that this was not a conclusive factor by itself. On the evidence, the taxpayers' operations constituted an adventure in the nature of trade.

Nevertheless, the case may encourage taxpayers to take the time and trouble to compile evidence to support their case (whether trading or not).

If the evidence points in one direction this reduces the possibility of the tribunal deciding the other way, but even if it does, there should be scope to appeal to the courts. HMRC acknowledge this point in their guidance (at [BIM20070](#) [6]).

### **Trade or venture?**

Even if an activity is insufficient to amount to a trade, it can still be treated as such for tax purposes if it is a venture in the nature of trade. But what is the difference between them? In broad terms, a 'trade' is normally established as a continuous operation with a degree of organisation or an infrastructure.

A 'venture in the nature of a trade' may lack those attributes but still display some characteristics of a trade. See **Music festival**.

### **Music festival**

Ted creates temporary facilities on some farmland to stage a music festival over a weekend during the summer, the audience being charged for admission. The festival is a success. Ted's operation is essentially the same as a concert hall, albeit that the ephemeral nature of the enterprise would disqualify it as a trade. It is therefore regarded as a 'venture' for tax purposes.

HMRC's view (see [BIM20065](#) [7]) is that a venture 'brings in transactions that might in some respects be less than full trading operations, but are sufficiently close to trade to be included in its meaning for tax purposes'.

Hobbies could be caught, although HMRC would probably argue that a hobby is not sufficiently commercial to amount to either if there is a history of losses.

HMRC's recently announced intention to target those who buy and sell goods on 'e-marketplaces' may trigger alarm bells, if occasional sales have escalated into something more.

It is worth noting that certain activities are specifically treated as trades by statute, such as farming and market gardening (ITTOIA 2005, s 9(1)).

By contrast, the occupation of woodlands in the UK on a commercial basis with a view to realising profit is not a trade for income tax purposes (ITTOIA 2005, s 11).

### **Conclusion**

Whether an activity constitutes a trade or a venture in the nature of trade is likely to be fact-specific, and circumstances will differ.

The message from case law (and HMRC guidance) is that the badges of trade should only be used as a general guide to the relevant principles.

The recommended approach can perhaps be summed up in *Marson v Morton*, where Sir Nicolas Browne-Wilkinson V-C said:

'I believe that in order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question ... was this an adventure in the nature of trade?'

This holistic approach is perhaps reminiscent of the 'elephant test' – difficult to describe, but you know one when you see one.

**Mark McLaughlin CTA (Fellow) ATT TEP** is a tax consultant to professional firms. He can be contacted by [email](#) [8]. He is managing editor of [TaxationWeb](#) [9] and editor of Bloomsbury Professional's *Core Tax Annuals 2011-12*.

Issue: Vol 167, Issue 4310 [10]

Wed, 29/06/2011

**Source URL:** <http://www.taxation.co.uk/taxation/Articles/2011/06/29/26112/youre-trading>

## 9. Reasonable excuse scorecard: Taxpayers 11 HMRC 7

Accounting Web. Posted Wed, 03/08/2011 - 11:35

*With the help of tax advisers, AccountingWEB has assembled a guide to the areas on which taxpayers have appealed late payment and filing penalties.*

Originating from an idea developed by Atlas Chambers barrister Anne Fairpo, we've come up with a scorecard of 'reasonable excuse' cases.

Fairpo came up with the idea after there had been a series of decisions against HMRC where it was clear that the tribunal were taking a more lenient view.

Seeing as **reasonable excuse** is not defined by legislation, the words must take on their ordinary meaning, and as such we thought it would be useful to keep track of what did, or didn't count as reasonable in decided cases.

In the interest of looking for trends, Anne Fairpo commented: "It's not really surprising that there is this degree of inconsistency: by definition, 'reasonable excuse' is a subjective test rather than objective and so there will always be variation in interpretation.

"HMRC staff are under increasing pressure with fewer resources and so will not have time to check what previous internal decisions on a topic have been, so staff are taking their own view. Much as 'no-one was ever fired for buying IBM', it's probably easier under pressure to err on the side of caution. Within government, that's not usually on the side of the taxpayer," Fairpo concluded.

Reasonable excuse - YES	Reasonable excuse - NO
"Failing to file returns on time"	"Ignorance of the law no excuse"
"Online filing difficulties"	"Should have considered other methods of making payment"
"Genuine mistake"	"Lack of technical wherewithal to comply with online filing requirement"
"Insufficiency of funds"	"Lack of letterbox not reasonable excuse"
"Late submission of a monthly Construction Industry Scheme return"	"Illness not reasonable excuse where doesn't coincide with period of default"
"Failing to submit a return of land transactions"	"Absence of part-time bookkeeper not a reasonable excuse"
"Late payments of VAT"	"Unspecified financial difficulties not reasonable excuse"
"Unaware old employer did not deduct all tax"	
"Difficulty with online filing facility"	
"Given misleading and incomplete information"	
"Believed his accountant would file the P35"	

## Reasonable excuse decisions - YES

### 1. Failing to file returns on time

#### *Humphreys v HMRC [2011] UKFTT 98*

This appeal concerned a taxpayer who posted his return four days before the deadline was fined when the return arrived late. The tribunal ruled that HMRC had been wrong to impose a penalty despite HMRC guidance stating that postal delays could only be considered 'reasonable excuse' in the most extreme circumstances. It found that **it was a reasonable excuse for a taxpayer to demonstrate that lateness was caused by misleading or inaccurate information being provided to him by the person who now seeks to levy a surcharge based upon that lateness.**

### 2. Online filing difficulties

#### *N A Dudley Electrical Contractors v HMRC [2011] UKFTT 260*

This electrical contractor appealed against a penalty imposed by HMRC consequent upon the late filing of a P35. The taxpayer had set out to file his return online expecting to be able to use HMRC's advertised online filing facility subsequently discovered that **he required additional software (a fact not highlighted by the advertising campaign)** and so filed a paper return and was late in the payment of the tax. The tribunal ruled that HMRC had been wrong to impose a penalty

### 3. Genuine mistake

#### *Leachman v HMRC [2011] UKFTT 261*

This taxpayer was fined for failing to file a P35 under **the mistaken belief that his accountant would do so** had the fine overturned by the tribunal which ruled that a genuine mistake can constitute a 'reasonable excuse'. It concluded that the situation was totally different to a situation where a taxpayer relies upon his agent do a particular act but the agent neglects to do it.

### 4. Insufficiency of funds

#### *Kincaid v HMRC [2011] UKFTT 225*

The appellant was unable to pay tax on time because of cashflow difficulties, partly caused by HMRC changing the taxpayer's status, under the Construction Industry Scheme. The tribunal went with the taxpayer against HMRC's written guidance resulting in fines being cancelled. It **found difficulties with HMRC's contention, due to the wording of the legislation**, and HMRC was unable to refer the tribunal to any previous decisions in support of their position on this point.

### 5. Late submission of a monthly Construction Industry Scheme return

#### *Mr Alan Thomas Davies v HMRC [2011] UKFTT 303*

This was an appeal by Mr Davies against a penalty of £100 imposed for the late submission of a monthly Construction Industry Scheme (CIS) return for the month ended 5 June 2010. The appellant relied on the advice and assistance of post office staff when the envelope was weighed for large letter postage. Although next day delivery is not always guaranteed, he had allowed at least three clear days for delivery of the return. In the circumstances **it was difficult to see what more the appellant could have done to ensure delivery on time.** The tribunal found that he had shown a reasonable excuse for the late delivery and allowed the appeal.

### 6. Failing to submit a return of land transactions

#### *Runham & Naramore v HMRC [2011] UKFTT 55*

Both appealed against the imposition of a flat rate penalty in the sum of £100 for failing to submit a return of land transactions before the end of the period of 30 days after the effective date of the transaction. The taxpayer's solicitor posted an SDLT return which was not received by HMRC. On telephoning HMRC to ask for the certificate of payment, the solicitor discovered that the return was not received. She **immediately filed the return online and paid the tax by electronic transfer.** The judge, on overturning the fine, pointed out that 'the tribunal is not bound by HMRC's construction of 'reasonable excuse'

## 7. Late payments of VAT

### *Dental IT v HMRC [2011] UKFTT 128*

MD Mr McNaughton appealed against default surcharges imposed for the late payments of VAT for the periods 01/10 and 04/10 totalling £1,245.74. The reliance on advice given by staff on an HMRC helpline was considered 'reasonable excuse' for a mistake in a tax return. The **appellant had acted on the misleading advice given by HMRC** and that there was a reasonable excuse.

## 8. Unaware old employer did not deduct all tax

### *Yusuf Budiadi v HMRC [2011] UKFTT 233*

Mr Budiadi left his employment with UBS and after leaving the company received a further payment. The company deducted only basic rate tax from the payment and not, as was appropriate, anything to reflect he was liable to higher rate income tax. He believed that all necessary tax had been deducted under the PAYE system. As **he was unaware that his employer had not deducted all tax that was properly deductible and payable** he satisfied the tribunal that a reasonable excuse existed.

## 9. Difficulty with online filing facility

### *Louise Fernandez v HMRC [2011] UKFTT 259*

The appellant had attempted to use the online filing facility provided by HMRC but found herself denied access to the site. She also sent e-mails to customer support seeking assistance. The tribunal found that she had a reasonable excuse because **the online filing facility provided by HMRC did not work as it should have worked** when she tried to use it and, furthermore, HMRC failed to provide her with the help that she had requested within a reasonable time. A second appeal was not allowed due to the reasonable excuse, to which the judge have referred, could not possibly apply to the continued failure to file.

## 10. Given misleading and incomplete information

### *Mr T J Fisher (T/a The Crispin) v HMRC [2011] UKFTT 235*

The appellant left the business and paid his employees up to date and issued them with P45s. As the business ceased, an employer's annual return should have been submitted to HMRC. No such return was made and HMRC sent a fixed penalty charge of £800. During a telephone call with the Revenue he requested advice as to what was required when he was closing his business. He was advised that he should send a letter, which he did, but **was not advised that any further returns would be necessary** once the PAYE deducted taxes had been paid up to date upon him issuing the forms P45. The appellant was **misled by omission rather than by commission**.

## 11. Believed his accountant would file the P35

### *Anthony Leachman t/a Whiteley and Leachman v HMRC [2011] UKFTT 261*

Mr Leachman appealed against a penalty notice issued by HMRC whereby it levied a penalty of £400 on the basis that his P35 had not been filed on time. The appellant argued that he has a reasonable excuse for the lateness and so no penalty should be levied. He believed that his accountant would file the P35 while his accountant believed that the appellant would personally attend to it. The tribunal found that if one person genuinely believes that another person is undertaking a particular task and that other person genuinely believes that the original person is undertaking that task, each is labouring under a mistake of fact. As such as a matter of law, **a mistake of fact is capable of amounting to a reasonable excuse**.

## Reasonable excuse decisions - NO

### 1. Ignorance of the law no excuse

#### *McCann v HMRC [2011] UKFTT 440*

Appeal was dismissed against the first surcharge imposed because of the late payment of tax. McCann had claimed that that the tax unpaid arose as a result of only basic rate tax being deducted from his redundancy payment, whereas a 40% deduction should have applied. The tribunal found that the he had no reasonable excuse for the late payment of the tax. **Ignorance of the law is no excuse and it was open to him to contact BP** at the time he received his P60 or soon afterwards.

## 2. Should have considered other methods of making payment

### *Blue Forest v HMRC [2011] UKFTT 447*

Blue Forest appealed against the imposition of a default surcharge of £699.34 under s 59 VATA 1994 because of the late payment of VAT. However the tribunal found that the appellant had the means to pay its VAT on time, and could have used a payment method that would not have resulted in late payment, but did not do so. It found that “**a reasonably diligent taxpayer would have considered other methods of making timely payment** if the method it first contemplated was not available.”

## 3. Lack of technical wherewithal to comply with online filing requirement

### *Kellswater v HMRC [2011] UKFTT 430*

The Kellswater Reformed Presbyterian Church appealed against the imposition of penalties of £400 for its failure to submit a P35 for the tax year ending 5 April 2010. The tribunal found that **a prudent employer would have availed itself of the help offered by HMRC in respect of online filing**, and explored options of seeking technical expertise outside the congregation.

## 4. Lack of letterbox not reasonable excuse

### *Rocco Mana t/a Spearmint Rhino Rouge v HMRC [2011] UKFTT 153*

Rocco Mana **lost its appeal against three default surcharges** levied on it in respect of its late payment of VAT. The First-tier Tribunal found the lap dancing company’s claim that it was unable to receive post as not a reasonable excuse. It found that **the company ought to have known its VAT liability**, the date on which it was due to be paid, and should have put in place an effective system for receiving its post.

## 5. Illness not reasonable excuse where doesn't coincide with period of default

### *RFL Consultants v HMRC [2011] UKFTT 431*

The appellant’s reason for default was that HMRC was high blood pressure in the month before the return was due. The tribunal found that the illness did not constitute a reasonable excuse because **the timing of the illness did not correspond to the period of default**. It was satisfied that the appellant’s actions were not those of a prudent employer exercising reasonable foresight and due diligence and having proper regard for its responsibilities under the Tax Acts.

## 6. Absence of part-time bookkeeper not a reasonable excuse

### *Grant Vehicle Repairs v HMRC [2011] UKFTT 420*

Company bookkeeper accepted that she had forgotten to send the VAT payment due on after her domestic partner arranged a “surprise” holiday. The return was submitted in good time, but the **payment was not received until eight days after the due date**. The tribunal found that the company director and secretary, who both had an involvement with the company’s general business administration, were available.

## 7. Unspecified financial difficulties not reasonable excuse

### *Impossible TV v HRMC [2011] UKFTT 413*

Delayed VAT payments arose as a result of the appellant having online banking problems when he came to arrange payment. The **tribunal was given no detail of these difficulties and not told whether they were solely the result of lack of knowledge** about limits on online payments or the result of computer or telephone line failure.

## 10. Tribunal slams HMRC's PAYE late penalty regime

Posted by John Stokdyk on Thu, 18/08/2011  
From accountingWEB Tax

*HMRC's habit of waiting several months before sending out penalty notices for late PAYE returns was roundly criticised last month by a tribunal judge in the case of **HMD Response International v HMRC***

"We are in no doubt that such a body does not act fairly when it deliberately desists from sending a penalty notice, for four months or more, knowing that the effect will be to impose a minimum penalty of £500 upon somebody whose sin may amount to no more than oversight or forgetfulness," commented Geraint Jones QC in a judgement striking down HMRC's £500 penalty claim against the charity.

The decision represents another defeat for HMRC's stance on "reasonable excuse", with the tribunal ruling that the condition could apply to a person who genuinely and honestly believed that a successful online filing had taken place. In the judge's interpretation, an appellant should not have to prove some exceptional circumstance to qualify for the concession. "HMRC has quite wrongly sought to elevate to something more onerous than the test specified by Parliament," the HMD Response ruling noted.

HMD Response International is a small charity that relies on its accountant John Williams to handle its annual employers PAYE end of year return. HMRC claimed not to have received a return for 2010 by 19 May, but the first HMD and its agent heard about it was via a penalty notice for £400 on 27 September - too late to meet the deadline for another £100 increment on the penalty.

Williams wrote to HMRC on 8 October seeking a review of the penalties, but was eventually informed by letter on 30 March 2011 that HMRC would uphold the fines.

What happened in the interim brought a particularly stinging rebuke from the tribunal. On 21 February 2011, while the case was still under review HMD received a letter from HMRC claiming the charity had been ignoring "our efforts to resolve the matter of your outstanding liability."

The ruling noted that the judges had seen no evidence of HMRC's efforts to resolve the situation and said that the "high-handed" threat to send bailiffs to seize goods from the charity was not justified. "It smacks more of the conduct of a disreputable debt collector than of responsible conduct by an organ of the state. It might have been better if HMRC had concentrated its efforts on dealing with the outstanding review, rather than taking almost six months to deal with it," the judges noted.

Paragraph 31 of the judgement explained: "HMRC is a manifestation of the state. It is no function of the state to use the penalty system as a cash generating scheme. The penalty system has a legitimate aim, which is to ensure that appropriate filings take place in good time and to discourage default. Given that that is the legitimate aim, it is inexplicable why HMRC deliberately delays sending out a penalty notice for four months, with the effect that a penalty for five months becomes payable... In our judgement it would be a very simple matter for HMRC to set its computer settings so that a default or penalty notice is sent out soon after 19 May in any year, instead of some four months later. That fair approach might generate less penalty cash for the State, but it would be fair and conscionable as between the taxpayer and the State (acting by HMRC)."

The judges held that as an arm of the state HMRC had a common law duty of fairness and cited the precedents set out in *R v SS Home Department [2003] EWCA Civ 364* (paragraph 69), and *SS Home Department v Thakur [2011] UKUT 151* (paragraph 12).

Their stance on reasonable excuse was also worthy of note. To qualify for a reasonable excuse reprieve, HMRC required the appellant to demonstrate during its review of the case that there had been some exceptional event that prevented HMD from sending its return on time. "As a matter of law, that is not the correct test and is totally misleading," the ruling noted. "Parliament has said that an appellant must demonstrate that it has a 'reasonable excuse'. Those are ordinary English words in everyday use. They must be given their ordinary and natural meaning.

*"If Parliament had intended to say that an appellant must prove some exceptional circumstance, it could and should have said so. It did not choose to say so."*

HMRC did not prove the alleged default in the case presented to the tribunal, and even if it had done so, the appellant established a reasonable excuse because its agent honestly and genuinely believed that the filing had taken place on the 16 May 2010.

Williams, who represented HMD at the tribunal, produced a contemporaneous note to the effect that he filed the return, but admitted to the judges that he could not be sure whether the submission had been successful or not. "He did not try to overplay his hand. In our judgement, he was a candid and honest witness. He said that he genuinely and honestly believed that the filing had successfully taken place," the judges wrote.

Even if there had been no reasonable excuse, the tribunal would have reduced the penalty to £100 because HMRC deliberately held off sending out a penalty notice until September 2010. In the circumstances of this case, however, the judges allowed the appeal in full and set aside the entire £500 penalty.

HMRC confirmed that it had not appealed against the HMD Response decision, but made it clear that it held a different view than the tribunal judge's. HMRC pointed out that of the very small proportion of disputes that go forward to tribunals each year, it typically wins in 7 out of 10 cases. Given the extra hassles that immediate penalty notices might cause companies and their agents during May-June, the department is also unlikely to heed the recommendation to reprogram its penalty issuing system. Reasonable excuse and PAYE penalty issues are unlikely to go away in the next few months - which could be one reason why HMRC is so keen on **Real Time Information**, which would do away with the year-end filing ritual.

The first tier tribunal decision does not set a legal precedent, but is further evidence that following the **Jusilla v Finland** European Court of Justice ruling in June, tribunal judges are taking a harder stance on the legal basis HMRC's penalty regime. Further commentary on this topic is available on our **Reasonable Excuse Scorecard**.

## **11. Revenue & Customs Brief 28/11 - VAT: Changes to the treatment of certain supplies made by employers under salary sacrifice arrangements following the CJEU Judgment in Case C-40/09**

28 July 2011

### **1.1 Background**

Astra Zeneca operated a flexible remuneration package scheme under which employees could opt to take part of their remuneration in the form of goods and/or services rather than as salary. The case before the Court of Justice of the European Union (CJEU) concerned the correct VAT treatment of high street shopping vouchers provided to employees as one of the options of the scheme.

The Court found that the provision of vouchers amounted to a supply of services effected for consideration. As a consequence, whilst Astra Zeneca was able to recover VAT incurred on acquiring the vouchers, output tax was due on the consideration received from its employees.

Although this case was concerned with the supply of vouchers to employees, the principles considered by the Court are of general application and will apply to other supplies of goods and services to employees.

### **1.2 The UK position on the provision of goods and services via salary sacrifice or deductions from salary**

Following earlier decisions by the UK courts, HM Revenue & Customs' (HMRC) policy was to make a distinction between the VAT treatment of supplies of goods and services to employees by a deduction from salary, and those provided under a salary sacrifice arrangement.

#### **1.2.1 Deduction from salary**

This occurs where an amount is deducted from an employee's pay in return for a supply of goods or services by the employer. Output tax has always been and continues to be due on the amount deducted from salary. Input tax is recoverable in accordance with the normal rules.

#### **1.2.2 Salary sacrifice**

For VAT purposes 'salary sacrifice' has a very narrow and specific meaning. It describes an arrangement such as in the Co-operative Insurance Society case [1992] (VTD 109) where an employee opts to receive services and forgoes part of their salary in return. The employee enters into a new employment contract or has their existing contract amended to reflect the new arrangement which they are tied into.

In relation to such schemes HMRC have, to date, accepted that the reduction in the salary did not constitute consideration for the benefits received and output tax was not due. Employers were able to recover the related VAT as input tax, subject to the normal rules.

In cases where the employee has been provided with the use of a good (for example a home computer) and opts to purchase it at the end of the scheme it has always been HMRC's view that VAT is due (where applicable) at that stage.

### **1.3 The Judgment of the CJEU**

The Court considered whether the provision of the vouchers was a supply for a consideration. It found that there was a direct link between the provision of the retail vouchers by the company to its employees and the part of the cash remuneration which the employees gave up.

As far as arrangements involving deductions from salaries are concerned, the judgment supports HMRC's existing policy that these are consideration for a supply for VAT purposes.

However, HMRC considers that the rationale used by the CJEU goes wider than deductions from salary, and as a consequence of this there is no longer a distinction between deductions from salary and a salary sacrifice. Therefore, the amount of salary foregone is consideration for supplies of the benefits whether provided under a salary sacrifice or by a deduction from salary.

It is clear that the principles applied by the CJEU are not confined to vouchers, but are equally applicable to many other situations where employers offer benefits to their staff. Where the benefit is subject to VAT, output tax will be due from, and input VAT recoverable by the employer in accordance with the normal rules.

#### **1.4 Implementation: Revised VAT treatment of salary sacrifice**

Businesses providing benefits under arrangements, which qualify as salary sacrifice schemes for VAT purposes, must account for output VAT on these supplies, where they are subject to VAT. In order to allow businesses time to make the necessary adjustments, HMRC will not require output tax to be accounted for on taxable benefits provided under salary sacrifice schemes, until 1 January 2012.

See the annex for details of how this change of practice will apply in particular circumstances.

### **2. Valuation**

In most cases the value of the benefit for VAT purposes will be the same as the amount of salary deducted or the amount foregone under a salary sacrifice arrangement. Where this is less than the true value (for example where employers supply the benefits at below what it cost to buy them in), the value should be based on the cost to the employer.

### **3. Direct Tax**

HMRC considers that the judgement is limited to the application of VAT legislation. The principle derived from the CJEU decision is concerned with whether, in the context of the provision of a benefit by an employer to an employee as part of the remuneration, that constitutes a supply of services affected for consideration. There is no comparable concept within tax law applicable to the taxation of employment income and HMRC will not be amending the existing published guidance relating to employment income issues.

Further advice

Where you are in any doubt about the correct VAT treatment please contact the VAT Helpline on Tel 0845 010 9000.

Annex

### **4. Effect of the CJEU judgment in particular circumstances**

#### **4.1 Cycle to Work Scheme**

Under the Cycle to Work Scheme employers purchase bicycles and safety equipment and provide them to employees. Where this has been done under a salary sacrifice arrangement, the effect of the judgment is that employers must account for output tax based on the value of the salary foregone by the employee in exchange for the hire or loan of a bicycle.

Affected businesses should apply this treatment from 1 January 2012. Employers can continue to recover VAT on the purchase of the bicycle and associated equipment.

Employers who have provided bicycles under deduction from salary arrangements are unaffected by the judgment as payments received from employees have always been subject to VAT and will continue to be so.

VAT remains due when a bicycle is disposed of and its value should normally be based on the price of an identical or similar item, taking into account the age and condition etc.

We are aware that valuing bicycles has caused difficulties for Scheme operators and therefore, to reduce administration burdens, the table used to value bicycles for direct tax purposes may be used. This table provides valuations for bicycles based on the age and original price. Any bicycles that fall outside of the table (such as antique or specialist bicycles) should be valued using the normal VAT valuation rules. If businesses choose to use lower values, they may be challenged in which case evidence will be required to support the valuation.

#### **4.2 Face Value Vouchers**

HMRC's published policy in relation to the provision of face value vouchers by employers to employees aligns with the judgment of the CJEU. In the case of supplies made under a deduction from salary arrangement input tax is recoverable but output tax must be declared. Where such vouchers have previously been provided under a salary sacrifice arrangement (as defined above) then input tax was claimable, subject to the normal rules, but output tax was due to the extent of the input tax claimed.

#### **4.3 Childcare vouchers**

Childcare vouchers are not directly affected by the judgment as they are not subject to VAT.

However, employers that incur administrative fees from their voucher provider have, to date, been permitted to recover VAT on those fees as a general business overhead. However, because the fees are directly attributable to the exempt supply of vouchers the normal partial exemption rules must be applied with the result that the VAT incurred may no longer be fully recoverable.

Affected businesses should apply this treatment from 1 January 2012.

#### **4.4 Food and catering provided by employers**

Employers may provide their staff with free or subsidised meals, snacks or drinks. Where employees pay for the meal etc, the normal VAT liability will apply.

If employees make no payment, VAT is not due (provided the benefit is available to all staff).

The judgment does not affect the VAT treatment where employees pay for their meals etc by a deduction from salary as VAT remains due.

However, from 1 January 2012 where employees pay for meals etc under a salary sacrifice arrangement, employers must account for VAT on the value of the supplies unless they are zero-rated. Subject to the normal rules, the employer can continue to recover the VAT incurred on related purchases.

HMRC are aware, that historically some employers have set up what they purport to be salary sacrifice arrangements to avoid VAT that is due on the consideration provided by employees for their meals, for example using electronic payments cards which record the value of consideration that is available to purchase meals. HMRC will continue to challenge such arrangements.

#### **4.5 Benefits provided to all employees for no deduction or reduction from salary**

The judgment only applies where an employee provides consideration in exchange for benefits. Where an employer provides, for example, a workplace gym which all employees may use for no deduction or reduction from their salary that will not fall within the scope of the judgment. Businesses may continue to recover VAT incurred on providing such facilities as a business overhead subject to the normal rules.

Separate charges to use facilities etc remain within the scope of VAT.

#### **4.6 Motor cars**

Most businesses are prevented from recovering VAT in full on the purchase and leasing of company motor cars. The input tax block on cars (100 per cent on purchases and 50 per cent on leasing) means that employers do not account for output tax when cars are made available to employees. Where VAT recovery is restricted and output VAT is not due the judgment has no direct impact.

Where an employer suffers no input tax restriction, output tax remains due.

Issued 28 July 2011

# PERSONAL TAX

## 12. Industry's reaction to Government consultation on residency rules

Published 20 June 2011

Released 20 June 2011

The government has announced plans to introduce a statutory residence test (SRT) in a bid to make the rules regarding the tax status of non domiciles easier to understand and implement.

Under the new proposals, the STR framework will take into account both the amount of time the individual spends in the UK and other connections they have in the UK. It also introduces a distinction between 'arrivers', that is those who are not UK resident in all of the previous three tax years, and 'leavers' who were resident in one or more of the previous three tax years.

The proposed test will be made up of three elements: conclusive non-residence factors, conclusive residence factors, and other connection and day-counting rules which will come into play only if the first two do not deliver a clear definition of an individual's status.

Leavers resident in one or more of the previous three will be deemed non-resident if they spend fewer than 10 days in the UK. They will be resident if they spend 183 days or more in the UK.

Arrivers will be non-resident if they spend fewer than 45 days in the UK and resident if their stay is over 183 days.

For varying lengths of stay in between those levels, a range of 'connection factors' will be taken into account, including family, accommodation, substantive work in the UK, spending more time in the UK than other countries and having a UK presence in the previous year.

Sean Drury, international mobility partner at PwC, gave the recommendations a cautious welcome but described the 10-day limit for leavers as 'extremely restrictive', calling for clear exemptions for events such as visiting ageing family members and specialist medical treatments.

Philip Fisher, head of employment tax and rewards at PKF, warned that 'ridiculously complicated' connection factors were 'a recipe for disaster' and likely to result in court cases to determine their precise working.

The government's consultation on the design and implementation of the STR framework is open until 9 September 2011.

The full article is available from Accountancy Magazine.

### 13. The proposed statutory residence test

<http://www.taxjournal.com/tj/articles/proposed-statutory-residence-test-28102>

Thursday, June 30, 2011

HMRC have a history of introducing detailed statutory definitions whenever case law in an area gets too complex or contentious.

Sometimes those definitions work well in practice. Sometimes they do not.

The definition of 'scheme of reconstruction' introduced by FA 2002 is a good example of the tension: like Marmite, some people love it, and some hate it.

In practical terms, the residence status of individuals has for many years been governed by two sources: some high-level statements made in ancient case law dating back to the 1920s, and one of the few Revenue publications with iconic status (leaflet IR20, and latterly HMRC6).

These HMRC publications provided detailed guidance on day-counting and other practical issues.

However, we now know that HMRC had not actively scrutinised many assertions of non-residence, and so a misunderstanding developed about the true meaning of various statements in IR20 (see the *Gaines-Cooper* judicial review [2010] EWCA Civ 83).

It has also become increasingly clear that the existing rules on residence are subtle and substance-based, and sometimes extraordinarily hard to apply in practice.

On 17 June, HMRC published a consultation document proposing a statutory definition of tax residence. (SRT) Paragraph 1.7 states a commitment to an SRT which is 'transparent, objective, and simple to use'.

The government believes that greater certainty will increase the attractiveness of the UK to external investors and that the SRT will provide a clear outcome for the majority of individuals.

Responses to the consultation are due by 9 September 2011. For such a substantial change, things are moving fast. The plan is for the test to come into force for tax year 2012/13.

The consultation document also addresses the case for reforming ordinary residence. This article does not consider that.

#### **Overview of the SRT**

The proposed SRT will comprise a self-assessed three-part test.

There is scope for a knockout blow for the taxpayer in Part A (conclusive non-residence).

If that does not apply, HMRC then has the chance for a knockout blow in Part B (conclusive residence).

Part C is more complex, and is to be used when neither of Parts A and B applies.

Part C involves a points system of 'connection factors' which are then judged against a sliding scale of days spent in the UK.

The proposed test applies to individuals only and covers income tax, inheritance tax and CGT but not national insurance contributions.

It will supersede all existing legislation, case law and guidance.

---

## **Investigation of whether taxpayers have given up their golf club memberships in the UK (or joined a snooker club abroad) should now be a thing of the past**

---

### **Three key definitions**

Many of the rules turn on 'presence' in the UK. A person will be treated as present in the UK where they are present in the UK at midnight at the end of that day (unless purely in transit): see paras 4.16 and 4.17.

In a nod to current case law, the tests in Part A and Part C of the SRT will ensure that residence is 'sticky'.

Under the proposed rules, it will be harder to become non-resident when leaving the UK than to remain non-resident when coming to the UK.

The proposals do this by characterising everyone as either 'Leavers' or 'Arrivers'.

Caution is needed with these tags, however. An Arriver is someone that has not been UK tax-resident in any of the previous three years. A Leaver is anyone else.

Someone coming to the UK for an extended period may fall into the 'Leaver' category from year two, and – as explained below – at least in the early years it may be very unclear whether someone is an Arriver or a Leaver.

### **Part A: conclusive non-residence**

In any tax year, Arrivers will not be UK resident if they are present in the UK for fewer than 45 days.

Leavers must be present in the UK for fewer than ten days to escape residence.

There is also a special provision for those who leave the UK to carry out full-time work abroad and are present in the UK for fewer than 90 days; and spend no more than 20 working days in the UK in a tax year.

Full-time work abroad and working day are defined, and a day can be a working day even if that person is not present in the UK at the end of that day.

Employers should remain conscious that more than 20 working days in the UK is a 'cliff's edge' for these individuals.

### **Part B: conclusive residence**

If Part A does not apply, individuals will be UK resident if they:

- are present in the UK for 183 days or more in a tax year; or
- have only one home and that home is in the UK (or have two or more homes and all of these are in the UK) – accommodation advertised for sale or let is excluded if the taxpayer lives elsewhere; or
- carry out full-time work in the UK (this definition is not quite the same as the definition of full-time work abroad).

### **Part C: connection factors and day counting**

Part C then applies to those individuals whose residence status is not conclusively determined by Part A or B.

Part C sets out four ‘connection factors’: a UK resident family, accessible accommodation in the UK, substantive UK employment (including self-employment), and 90 days or more spent in the UK in either of the previous two tax years.

It adds a fifth which applies only to Leavers: more days spent in the UK than in any other single country in that tax year.

Those five connection factors are compared against days spent in the UK according to separate ‘sliding scales’ for Arrivers and Leavers (see the Table).

**Table: Sliding scale – connection factors triggering residency**

Days spent in the UK	Minimum number of ‘connection factors’ to trigger residency	
	Arrivers	Leavers
Fewer than 10	Non-resident (Part A)	Non-resident (Part A)
10 – 44	Non-resident (Part A)	4
45 – 89	4	3
90 – 119	3	2
120 – 182	2	1
183 or more	Resident (Part B)	Resident (Part B)

### Other issues

The SRT is intended to retain and formalise the ‘split year’ treatment available in certain circumstances set out in ESCs A11, D2 and A78.

However, a tax year will not be treated as split where an individual’s residence status changes due to changes in the number of connection factors under Part C.

The SRT proposes anti-avoidance provisions modelled on those currently applicable to CGT (seemingly, TCGA 1992 s 10A).

The key objective is to deter people from becoming non-resident for short periods of time to avoid UK tax liability on expected income.

### Comment

The SRT aims to be transparent, objective and simple to use. Like any new set of rules it will appear daunting at first, but there is a substantial prospect that when things have settled down it will be seen as a straightforward part of life.

In practical terms, airline stubs, credit card receipts and mobile phone records remain important.

Pleasingly, investigation of whether taxpayers have given up their golf club memberships in the UK (or joined a snooker club abroad) should now be a thing of the past.

There is, of course, no indication of a corresponding test being applied to corporates.

Two main areas of uncertainty and judgment remain.

---

## Policy concerns exist over the application of the UK resident family connection factor

---

First, the SRT is not intended to apply retrospectively. However, the proposal goes further (see para 3.57).

Despite the fact that identifying someone as an Arriver or a Leaver will depend on whether an individual was resident in previous tax years, the new SRT will not apply for tax years 2009/10, 2010/11 and 2011/12, even for this limited purpose.

Therefore taxpayers must self-assess their UK residence under the current law for years prior to the new legislation.

This is a problem which could have indefinite knock-on effects. HMRC welcome comments.

Second, for individuals also resident (under local law) in a state with a DTA with the UK, there will be a need to engage the treaty tie-breaker clause.

Under the OECD model, this will involve assessment of the individual's 'centre of vital interests' or 'habitual abode'.

Some detailed issues have arisen already. Policy concerns exist over the application of the UK-resident family connection factor.

The definition means that a non-resident individual separated from their spouse or partner may be discouraged from spending more than 60 days with their UK-resident minor children regardless of where this time is spent.

To do so could compromise their residency status.

The conclusive residence test in Part B, which applies where an individual has 'only one home and that home is in the UK (or has two or more homes and all of these are in the UK)', could have unintended consequences for the wealthy.

It is not difficult to imagine a situation where this would catch an individual who has multiple homes in various jurisdictions, most of which are owned by various family trusts but one of which happens to be in his own name in the UK.

The proposed treatment of split years requires more detail for Leavers.

The new rules will treat a tax year as being split into periods of residence and non-residence if a person establishes their only home in a country outside the UK and becomes tax resident in that country and does not come back to the UK in that tax year (emphasis added).

The 'only home' requirement is onerous there is no definition yet of 'home', and there is a question on when the overseas tax residence must start and how it is proved.

For jurisdictions with no income tax or which assess tax residence strictly on a year-by-year basis (often calendar year by calendar year) there may well be problems of evidence.

Finally, HMRC have proposed an online self-assessment tool to allow taxpayers to determine their residency status 'without the need to resort to specialist advice'.

They have published a beta version online and seek comment on this.

The intention seems to be for the guidance from this to be binding on HMRC (as IR20 was held to be binding in *Gaines-Cooper*, and as helpline advice can be binding in appropriate limited circumstances: see *Noor v HMRC* [2011] UKFTT 349 (TC)).

To avoid a rerun of the Gaines-Cooper saga, this must be made clear.

**Heather Gething, Head of Tax Planning and Disputes, Herbert Smith**

**Rupert Shiers, Tax Disputes Partner, Herbert Smith**

14. Christopher Lunn & Company (“CLAC”)



**Local Compliance  
Small & Medium Enterprises**

8th Floor  
Castle House  
31 Lisbon Street  
Leeds  
LS1 4SW

**Tel** 0113 228 3693  
8.30am to 4.30pm Monday to Friday

[www.hmrc.gov.uk](http://www.hmrc.gov.uk)

**Date** 29 July 2011  
**Our ref** 388//EDG /LLL/8  
**Your ref**

Dear

**Denis Christopher Lunn, Christopher Lunn and Company and Christopher Lunn and Company Limited – together “CLAC”**

I have previously written to you as a client or previous client of “CLAC”. This letter provides you with an update of the current position.

On the 18 March 2011 I told you that following a Judicial Review decision, the Court ruled that the Commissioners for H.M. Revenue and Customs’ (HMRC) decision to stop dealing with “CLAC” was procedurally flawed because “CLAC” had not been given the chance to make representations.

On reconsideration the Commissioners invited CLAC to make representations. CLAC duly submitted representations to the Commissioners on 21 April 2011.

After careful consideration of the representations the Commissioners have decided that HMRC shall cease to deal with “CLAC” as a tax agent. This includes communications in writing, via the telephone or by any electronic means. CLAC will no longer be dealt with due to its unacceptable practices as a tax agent.

HMRC takes its responsibilities to its customers very seriously and as such we feel it is important to inform taxpayers on whose behalf “CLAC” has submitted returns of the action that HMRC has decided to take in relation to “CLAC”.

If you have appointed another tax agent you may want to share this letter with them.

I have explained that information from the ongoing examination of documents indicated that Tax Returns submitted to HMRC may not be correct for a number of reasons.

My letter(s) explained that in due course I would be checking your Tax Returns. I asked that if you thought your Tax Returns contained irregularities you should contact me.

I have noted that to date you have not contacted me with the intention of making a full disclosure. I will now be checking your Tax Returns and if I identify any irregularities then I will deal with those matters either by criminal or civil procedures open to HMRC depending on the nature of those irregularities.

Please note that until we have checked your Tax Returns HMRC will not be making any repayment of monies shown as being overpaid.

If you think your Tax Returns may be incorrect you should write to me or call on the above telephone number quoting the reference "Edgewood".

Yours sincerely

*M Garrahy*

**M Garrahy**  
HM Revenue & Customs

## 15. Is it too easy?

Appointing a corporate partner to a partnership is not as simple as it seems, explains JAN ELLIS

### KEY POINTS

- Nature of the partnership.
- Complications surrounding goodwill.
- Mitigating a charge under the employment-related securities rules.
- Possible application of IR35.
- Bring in a corporate partner from the start rather than later.

The position relating to corporate partners in a partnership or members of a limited liability partnership (LLP) has been the subject of a number of questions in the Readers Forum recently.

In this article, I will explore the issue in more depth, and show that it is not necessarily as straightforward as it looks.

### Why do it?

With corporation tax rates falling and personal tax and National Insurance rates rising, there are, at first sight, potentially significant tax savings to be made from incorporation.

Assuming a profit share of (i) £50,000; (ii) £100,000; and (iii) £200,000 and no other income, pension payments, associated companies etc, and that no salary at all is taken from the company (thereby breaking the individual's National Insurance contribution record, which has its own potential future consequences) and that all profits are paid out to the individual partner or shareholder of the corporate partner, the basic tax liabilities and net of tax receipts are as follows.

a) Profit share	£50,000	£100,000	£200,000
Income tax and NI	£13,463	£34,463	£84,453
<b>Net drawings</b>	<b>£36,537</b>	<b>£65,537</b>	<b>£115,547</b>
b) Profit share	£50,000	£100,000	£200,000
Corporation tax at 20%	£10,000	£20,000	£40,000
Dividend tax	Nil	£9,381	£32,360
<b>Net receipts</b>	<b>£40,000</b>	<b>£70,619</b>	<b>£127,640</b>

Note that the existing partnership deed will need to be amended for any corporate partner and, depending on how various potential complications are handled, the changes may be significant.

The amendment entails someone paying the necessary legal fees and the partnership as a whole accepting the changes which are suggested.

Depending on the position of other partners and the size of the partnership, this may not be straightforward.

### First things first

In considering the further tax implications of bringing in one or more corporate partners to a partnership, we first need to consider some basic issues, which may colour the answers to the tax points:

Is this a 'normal' English partnership, a Scottish partnership, or a limited liability partnership?

Remember that, unlike an English partnership, a Scottish partnership or LLP is a separate legal body. Does it currently have a sophisticated partnership or LLP deed?

Is the partner considering incorporation on a fixed share of profits, e.g. £60,000 a year regardless of overall profits; a fixed percentage share, e.g. one third of whatever profits are made; or a profit share which varies both in amount and percentage from year to year?

How many partners are there, and how many are considering incorporation? Will partners continue as individuals and run a corporate partner alongside their personal ownership, or incorporate their whole interest? How do the other partners view one or more partners establishing a corporate partner?

What is the individual's overall position and view of the other partners, e.g. how long he expects to be with the firm and his current and future earnings profile?

What might happen in the event of future dispute or if the corporate partner became an unexpected leaver, or if the individual died (after incorporating his interest)?

### **Selling goodwill or not?**

The tax savings shown in the table above may be enhanced if the partner can sell goodwill to the corporate partner, and claim entrepreneurs' relief on the consequent gain.

The company would 'buy' goodwill at deemed market value, for an amount left on the directors' loan account, and the loan account figure would be drawn down over the years from the company's future profit share, reducing the amount taken out as dividends. That is the theory at least.

There are, however, a number of potential complications.

### **Valuable goodwill**

First, is there any valuable goodwill in the business, and if so, how much relates to our individual partner?

If he is a 'fixed share' partner, there may be no value to his share of overall goodwill: he is presumably paid market rate for what he does, and a goodwill valuation requires us to capitalise 'super-profits', i.e. profit share in excess of market remuneration.

A partner on a percentage of profits, or a fluctuating share, will also need to show that his profit share over the years is more than just remuneration and includes some element of super-profit in respect of being a co-owner of the business.

For a very small partnership, HMRC may also question whether any goodwill is 'personal' goodwill, which lies with the individual.

The answer here will depend on the facts: for a highly specialised or niche business this is more likely to be true than, say, for an accountancy practice with a solid compliance base.

Remember that you cannot pre-test the valuation, so it is best to have a 'price adjuster' clause in place to ensure the amount payable by the company and taxable on the individual (after any HMRC review) are the same.

### **Entrepreneurs' relief**

Second, will entrepreneurs' relief be available? If not, capital gains tax rates on any notional gain will be higher (18% or 28%) than dividend tax at basic or higher rates (effective rates of nil and 25%).

Unlike taper relief, for entrepreneurs' relief it is not enough to sell business assets: the sale must be of a business or part of a business. This may easily be demonstrated when a whole partnership incorporates, but is it met for a single partner?

Are other assets being sold to the corporate member (such as a percentage of fixed assets, work-in-progress and debtors), or is the new company, in reality, only picking up the individual partner's share of off-balance sheet goodwill?

It is not known where HMRC will draw the line here: remember that there is no entrepreneurs' relief case law yet; the retirement relief cases deal mainly with farm acreage and so are of limited use.

### **Need for goodwill**

Third, do you really want the goodwill in the company? If the partnership is sold, a gain will potentially crystallise in the company on its share of the total (under the intangible assets regime), with corporation tax payable, and then a second layer of tax payable on extracting cash from the company.

If a sale of the whole is unlikely but you liquidate the corporate partner in the future, this may nonetheless result in a (market) disposal of goodwill by the company and corporation tax being paid on any gain.

It will also be necessary to consider depreciation and amortisation of the purchased goodwill in the company, and the consequent impact on distributable reserves. The implications of pre- and post-2002 goodwill also need to be considered.

### **Debts**

Fourth: consider the practicalities. The capital gains tax on the disposal of the goodwill will be due on 31 January after the tax year of sale. The individual must have drawn down enough profits by then to pay the tax due.

If the sale or price to be paid is in some way contingent, there may be scope to revisit the taxable value if the unexpected happens. If not, consider what happens if, for whatever reason, the corporate partner leaves the partnership before repaying the full loan.

Is the individual who sold his goodwill content that the company still owes part of the purchase price, but is unable to repay the debt without a sale of goodwill or a new income source?

Do the remaining partners want the now dormant company to own some of the overall partnership goodwill or will they require 'bad leaver' provisions to enable them to get the goodwill back if there is a falling out, or the individual dies?

What happens if the individual wants to transfer his shares in the corporate partner to someone else? Can the other partners block this? Once you delve into the possibilities here, you soon realise why most businesses keep goodwill firmly off balance sheet with no payments to 'leavers' or by 'joiners'.

### **Anti-avoidance**

Fifth, is there a risk of anti-avoidance rules applying? Answers to previous Readers Forum queries have referred to the anti-avoidance legislation in **ITA 2007, s 773 [2]** (previously **TA 1988, s 775 [3]**) and an extract from HMRC's *Business Income Manual* BIM35955, 'Sale of income by an individual in exchange for capital: conditions needed':

'The following conditions must all be present before TA 1988, s 775 can operate.

'The individual must be carrying on an activity or occupation of the kind covered by the section (BIM35960).

'Transactions or arrangements must have been effected putting some other person in a position to exploit the earnings capacity of that individual.

'A 'capital amount' (BIM35965) must have been obtained by the individual or some other person, as part of, or in connection with, or in consideration of the transactions or arrangements.

'The main object, or one of the main objects, of the transactions or arrangements must be the avoidance or reduction of liability to IT.

'The effect of the section is that the 'capital amount' is chargeable on the individual as income under Case VI of Schedule D in the tax year or years in which it becomes receivable (BIM35970). The 'capital amount' will not be consideration for CGT purposes (CG14303).'

I have never seen this legislation employed, for example, on the incorporation of a sole trader with payments for goodwill: it is possible that the move in that situation from unlimited to limited liability is enough commercial reason to disapply the section.

With the introduction of a corporate partner to an existing business, rather than establishing a new partnership with corporate partners from the start, I would suggest it would be sensible to have a serious commercial rationale for the new partner beyond the obvious tax savings.

### **Employment-related securities**

The next hurdle is the employment related securities legislation. Our partner will undoubtedly be a director of the company which becomes a corporate partner, and so he will be deemed to have acquired the shares by reason of his employment (**ITEPA 2003, s 421B(3) [4]**).

He has doubtless paid in a nominal amount only for the shares, but incorporates the company knowing it will shortly sign up to the partnership deed and take a profit share.

If the company is not paying for goodwill transferred to it, is it right then to say that the value of the shares is negligible?

Remember that HMRC will charge income tax on the director/shareholder on any element of underpayment.

It is usual to argue that the initial value of a start-up company is modest but here, the company is joining a pre-existing partnership and presumably expected to be profitable immediately.

If it is becoming a de facto equity partner, it may be required to buy in to the partnership, so that any payments made by the individual as partner previously are transferred to it, but such amounts are usually modest compared with annual profit share.

If the profit share going into the company is a regular amount or percentage, it may be difficult to defend an argument from HMRC that the shares in the corporate member are valuable.

I would suggest that the best way to minimise the risk of a charge under the employment related securities rules is, first for a partner to maintain his personal partnership and, second to share his overall profits between himself and the corporate partner in a way that makes the amount receivable by the corporate partner irregular or unpredictable, and so difficult to attribute a high value to.

### **Transactions in securities**

Setting up a corporate partner is, in itself, a transaction involving securities, so it is worth looking at the rules in the context of establishing the corporate partner.

These rules apply, in general, to transactions where a person obtains a tax advantage within one of the circumstances in **ITA 2007, s 686 [5]** to **s 690 [6]**, without having a genuine commercial reason for the transaction. There are now two conditions which can trigger the charge, based on the old circumstances D and E.

They only apply when relevant consideration is received in connection with a transaction in securities, and income tax is not charged on the consideration.

The first condition, A, is the receipt of consideration in connection with the distribution of assets from a close company; the second, B, is where two or more close companies are connected with the transaction.

'Company' is defined in **ITA 2007, s 992 [7]** as 'any body corporate or unincorporated association, but does not include a partnership...'

There is no separate reference to an LLP in s 992, but BIM72115 states: 'Although in general law an LLP is regarded as a 'body corporate', for tax purposes an LLP is normally treated as a 'partnership.'

It therefore seems reasonable to assume that the transactions in securities legislation will not apply to the creation of the corporate partner and its receipt of profit share from the partnership per se from a traditional partnership, but might the rules apply subsequently, for example to payments made from the corporate partner to its shareholder?

### Other points

If the previous partner was treated as self-employed, it is unlikely that the IR35 rules will apply to the new company; in particular, if the partnership is structured as an LLP, HMRC will invariably treat all partners (even those on a fixed share) as self employed.

The new company should be treated as a trading company for capital gains tax and business property relief purposes.

If a number of corporate partners are brought into a partnership, they are counted as associated companies for small company rate purposes.

This is because they are treated as under common control, even if partner A controls one and unrelated partner B controls the other, as the control test is looked at in conjunction with the participator's associates and these include his business partners.

This is logical as to the aims of the legislation, otherwise lower corporation tax would be paid in aggregate than if all the partners traded as a single corporate entity with different shareholders.

If the individual stands down as a partner at the same time as the corporate partner is brought in, he will crystallise tax on a cessation basis, albeit with overlap relief. For a long-term partner in a business which has grown significantly, this could be very unattractive.

In contrast, if he maintains his partnership and has the flexibility to share profits with the corporate partner as he wants, there may be scope to exploit when tax is paid in terms of individual versus corporate payment dates and calculations of income tax payments on account.

If the partner is in the happy position of earning more than he spends, an additional benefit of having a corporate partner is the ability to pay corporation tax on profit share now, and pay income tax on drawings potentially at lower rates in later years by managing dividend flows or liquidating the company and claiming entrepreneurs' relief.

Assuming he can manage the risks of a corporate partner discussed above, this could result in his partner company being a very useful money-box device. This is demonstrated in **Money box**.

### MONEY BOX

If a partner has an annual profit share in the region of £200,000, has a lifestyle which costs him £50,000 (net) a year, and his fellow partners allow him to set up a corporate member and split his profit shares as he likes between himself and his company, he could decide to put half into his own hands: profit share £100,000; net £65,537, and pay a net pension contribution out of this leaving net personal profits of £50,000 for his personal needs, and put £100,000 gross/£80,000 net into the company.

After a few years, the net cash in the company has built up nicely – effectively into an additional pension pot, from which he can potentially withdraw tax-free as a basic-rate taxpayer, after he retires.

## Conclusion

It may be easier with new structures to establish a partnership or LLP with corporate members from the start, rather than add them in later. The employment related securities rules, in particular, are much less likely to bite with a start-up enterprise.

Having recently crunched the numbers on a sole trader looking at possible incorporation or restructure as an LLP with personal and corporate members, it worked better with a straight incorporation, including the Newco buying goodwill in the usual way.

For an existing business, I would be wary of paying for goodwill and hoping to secure entrepreneurs' relief. I would think carefully about the employment related securities legislation.

With a reasonable sized partnership, you will incur legal fees in producing a revised partnership deed which deals with all the details of a corporate partner, including death, retirement, dispute and non-compete issues.

Furthermore, the other partners may want comfort on a number of specific issues relating to the company's own articles etc, especially if goodwill has been sold to the company, to ensure they do not end up in partnership with a company now owned by the wrong person, or with a former corporate partner still owning some of the overall goodwill.

These costs, along with additional compliance costs in relation to the company, as well as the potential for corporation tax at higher rates because of associated companies, need to be factored into the cost/savings analysis.

It is also important to discuss the wider implications with the client, particularly if a payment is to be made for goodwill as, in due course, either the company must dispose of the goodwill it holds – prior to a liquidation or striking off – or the shares transferred to a continuing partner. The issues surrounding leavers become more complex.

In summary, I think there is a place for corporate partners, but it is not straightforward.

***Jan Ellis can be contacted via email [8] and on 01444 484193***

Taxation. Issue: Vol 168, Issue 4314 [9]  
Wed, 27/07/2011

---

**Source URL:** <http://www.taxation.co.uk/taxation/Articles/2011/07/27/27322/it-too-easy>

---