AAT Tax update - 31 May 2014

In this monthly edition of the tax update we look at:

1 House of Lords Committee recommends reform of IR35
2 Icebreaker tax avoidance scheme fails and stars get adverse publicity
3 Toolkits for Income tax losses and non-business private expenditure published
4 Naming and shaming: HMRC publish detail of more deliberate defaulters
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6 Car benefit law traps another company and individuals but statutory discovery limits HMRC's recovery of tax and NIC

1. House of Lords Committee recommends reform of IR35

I have to declare a conflict of interest when it comes to IR35 because, since its inception, I have believed it was bad law and should never have been enacted. Legislation which creates a fiscal fiction deeming things to be something else by examining each contract in a hypothetical context is inappropriate for a self-assessment regime.

IR35 should never have been enacted but once the parliamentarians had made that mistake, it should quickly have been repealed. The fact that it is still on the statute book 15 years after the mistake of enacting such bad legislation should be a cause of shame to everyone in HMRC and to those parliamentarians who were so lacking in common sense to enact it.

Many have criticised the IR35 legislation and now the House of Lords (HoL) has added its weight in a 66 page report. The HoL committee recommended that HMRC:

- clarify the cost of IR35 compliance work and administration and the relationship between those costs and the overall yield (Recommendation 7, paragraph 113)
- help taxpayers potentially affected by the IR35 trap by publicizing the HMRC contract review service to greater effect and consider how to increase public confidence in its "independence and impartiality" (Recommendation 8, paragraph 123)
- consult on improving the business entity tests to provide greater certainty (Recommendation 9, paragraph 134)
- Government should develop and publish a short guide setting out the basic differences between employment and self-employment (Recommendation 11, paragraph 164).

You can read the full 66 page report at:
http://www.publications.parliament.uk/pa/ld201314/ldselect/ldpersonal/160/160.pdf

The risk to HMRC with IR35 is that profit from the company is extracted by way of dividend thereby saving NIC. The solution is to limit the dividend to say a 9% return on capital with anything exceeding that limit facing NIC or an equivalent. IR35 remains bad law and should be repealed.

2. Icebreaker tax avoidance scheme fails and stars get adverse publicity

Although the appeal hearing for five limited liability partnerships, Acornwood LLP (2005- 06 loss of £5,199,166), Bastionspark LLP (2006-07 loss of £4,883,792), Edgedale LLP (2007-08 loss of £6,496,686), Starbrooke LLP (2008-09 loss of £6,820,283) and Hawksbridge LLP (2009-10 loss of £5,628,653) and seven individuals occurred in November 2012, the 147 page decision in favour of HMRC has only just been published in May 2014. The appeal was a test case and a further 46 partnerships are named in the appendix so the amount of loss relief being claimed was substantial.

Each partnership entered into various agreements for the acquisition and exploitation of certain intellectual property rights. Each partnership acquired a set of such rights, for relatively modest sums, and for much larger payments agreed with an exploitation company that it would exploit the rights so acquired on its behalf. The revenue from the exploitation was to be shared between the partnership and the exploitation company, which was required in addition, as part of the arrangements, to pay certain guaranteed sums to the partnership.

In addition, each partnership entered into agreements with the promoter of the arrangements by which, in return for substantial payments, the promoter rendered, or was to render, various services to the partnership. The members' capital injections which financed the payments were in each case derived in part from their own resources and in part from secured borrowings from a bank; the borrowing and security arrangements represent a significant feature of the case.

The expenditure outlined above was incurred in each partnership's first accounting period and commonly, though not invariably, immediately after the members joined. The guaranteed returns the members were to receive were sufficient to enable them to service and repay their secured borrowings.

The ultimate underlying difference between the parties (HMRC and the individuals claim loss relief) relates to the extent, if at all, to which the first-year expenditure gives rise to an accounting loss which the members of each partnership may utilise, in their respective shares, by way of sideways relief against their income tax or capital gains tax liabilities.

These were marketed as tax avoidance schemes and HMRC contended that the partnerships' true purpose, which was the manufacture of artificial losses, was not matched by true economic losses, with the aim of generating relief against tax.

The Tribunal held the partnerships had failed to satisfy the statutory conditions so as to qualify for relief and, in addition, the members of the partnerships were not actively involved. The amount borrowed by the partners was never used to make a qualifying investment. The money was simply held to pay a guaranteed return to the investors, which were bound to pass the same funds back to the lending banks. In other words, Para 146, the borrowing had, and could only ever have had, an entirely circular purpose. The agreements for borrowing, guarantee and repayment were a means of increasing, without risk, the apparent size of the amount paid for the exploitation of the intellectual property rights each partnership had acquired (para 147).

Summarising such a lengthy and complex decision is not easy but in essence the accounts of the partnerships did not comply with UK GAAP. The FTT found that the payments to the exploitation company which represented the purchase of a guaranteed income stream were of a capital nature while the remainder were of an income nature. The advisory fees paid immediately by all but one of the appellant partnerships were all of a capital nature.

This persuasive decision has received a lot of publicity because it is alleged that various celebrities were involved and will now face substantial tax liabilities. With the restrictions in loss set off (see the toolkit which HMRC have introduced for 2013/14 below) the scheme would fail.

The messages following the decision are:

- Nearly 9 years have passed since the attempt to shelter income from 2005/06 occurred and people's circumstances may have changed in the intervening period. For some, the payment of the tax now due may cause difficulty
- Looking at the bigger picture, some of the individuals who tried to avoid tax using the scheme may find that their business is adversely affected. They will have faced many years of uncertainty regarding their tax affairs.
- If it looks artificial and applying the 'smell test' suggests it stinks, it might be better not to try avoidance schemes.

The full decision can be read at:
http://www.financeandtaxtribunals.gov.uk/judgmentfiles/j7741/TC03545.pdf

3. Toolkits to help minimise common errors - update

On 22 May 2014 HMRC published 2 updated toolkits designed to help agents check common errors for 2013/14 returns: Income Tax Losses (18 pages) from 2013-14 there is a further limit on the amount of income tax relief that an individual may claim for deduction from their total income in a tax year. The limit in each tax year is the greater of £50,000 or 25 per cent of the individual's adjusted total income. The other toolkit is on Private and Personal Expenditure (21 pages). These updated toolkits include new functionality that allows users to save electronically or print client information.

4. Naming and Shaming: HMRC publish details of more deliberate defaulters

Publishing details of deliberate defaulters (PDF 120K) [Link: http://www.hmrc.gov.uk/defaulters/defaulters-list.pdf]

The list of deliberate defaulters now runs to 21 pages. In principle, I think this policy is wrong because naming and shaming someone in a small community will have a different effect than naming someone in a large anonymous city. I note however that some of those named and shamed in this recent list published on 20 May 2014 have their details published as formerly of a particular address.

The policy of naming and shaming should deter potential defaulters because anyone who has deliberately defaulted on their tax responsibilities exceeding the threshold will have their details published by HMRC. HMRC has published its fifth list of deliberate defaulters who meet the conditions.

5. HMRC website to improve with migration of the website

HMRC's web guidance and tools are moving to the cross-Government **at** https://www.gov.uk/ website. Statutory Pay and High Income Child Benefit Charge content has moved, with 'customers' being automatically redirected from the HMRC website to GOV.UK. HMRC have also been working with the Government Digital Service to develop new (or updated) content for Tax Credits, Child Benefit, PAYE and VAT, which will soon be available on GOV.UK.

HMRC are developing a new service for their technical manuals too. HMRC have selected the Employment Income Manual as the test case because it is heavily used, both by HMRC and external customers – and it contains all the features needed to test users' needs.

6. Car benefit law traps another company and individuals but statutory discovery limits HMRC's recovery of tax and NIC

The original purpose of the discovery provisions found in s29 TMA 1970 was to strike a balance that protected HMRC's ability to assess tax which ought to have been paid but giving taxpayers who disclosed fully the position the certainty about their tax liability after the enquiry window has closed.

The Veltema decision frustrated the intention of Parliament and the law but gave HMRC extended powers to assess earlier years for tax and NIC. It is a poor decision but one which pleases HMRC and there is absolutely no political will to correct the defect which the Court of Appeal decision created.

In MC & LJ Ive Ltd & Anor [2014] TC 03529**,** a HMRC compliance visit identified cars that had not been reported as benefits in kind and correspondence then ensued between HMRC and the taxpayer's accountant but it was some three years later when HMRC notified the taxpayer they were checking four years' returns and opened a TMA 1970, s.9A enquiry into the fifth year (by which stage the fifth was the only year still within enquiry time limits). Discovery assessments were subsequently raised in respect of the four earlier years but the FTT found that the compliance visit itself and early correspondence was enough to have alerted HMRC to the loss of tax.

The taxpayer had sought professional advice on the arrangements regarding the cars and the FTT found that though the taxpayer's position was incorrect, they had acted with reasonable care. The difference between 'a failure to take reasonable care' and a mistake is a 6 year time limit for the former and a four year time limit for the latter. So the earliest year of assessment was out of time.

The taxpayer challenged the validity of the discovery assessments and also argued that the car benefit charges did not arise because although the company had leased the cars, this was only to secure the best commercial deal and cheaper rentals. The lease rentals, although paid by the company, were charged to the director's loan account; the cars were not shown in the company accounts and the taxpayer paid all fuel and maintenance bills privately and claimed a mileage allowance from the company at the 'scale rate'.

At this stage, those familiar with the Whitby and Another v HMRC (2009) UK FTT 311 decision and that of Stanford Management Services v CIR (2010) UK FTT 98 Management will know that the taxpayer is going to lose the argument. The provisions in ss114 to 118 ITEPA 2003 create another of those fiscal fictions which deems the car to be supplied by the employer even though the employee is bearing all the costs.

It was open to the taxpayer to lease the cars in his own name but he had decided that the company should lease them and then provide the use of them to him. The FTT upheld the Class 1A determinations on the cars and also the assessments on the utility bills of two employees relating to their accommodation expenses.

http://www.bailii.org/uk/cases/UKFTT/TC/2014/TC03529.html

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Set your diaries for the next edition of the general tax update which will be published on 30 June 2014

The views expressed in these podcasts are Derek Allen's personal views and do not necessarily represent AAT policy or strategy.