Tax update 30 April 2016

In this tax update we look at:

1. discovery assessments and protection for full disclosure
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4. Finance Bill progress and Royal Assent
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1. Discovery assessments and protection for full disclosure

When the Court of Appeal decided in Langham v Veltema that anything short of a disclosure which highlighted that there was an insufficiency of income and gains did not give the taxpayer protection from discovery, the decision established legal precedence. However, it was a bad decision and the law should have been changed to remedy the balance to give self-assessing taxpayers the right to certainty once the enquiry window has passed. The problem is that there is no political will to remedy the bad law which now applies.

In 2000/01 Mr Hargreaves had arranged to become non-resident for tax purposes from March 2000 after which he made capital gains of some £84m on the sale of a shareholding in Matalan plc, which he had founded. HMRC issued a discovery assessment on the basis that Mr Hargreaves was not entitled to be treated as neither resident nor ordinarily resident in the UK for tax purposes in 2000/01.

Now this is complex because Mr Hargreaves had relied on IR20, and with hindsight and the Supreme Court decision in R (Gaines-Cooper) v HMRC [2011] STC 2249, he has to show that he had effected a distinct break in his pattern of life in the UK and that would involve a multifactorial inquiry.

Mr Hargreaves wanted any legal disputes to be separated and his argument was that he had made sufficient disclosure in his return to alert the Inland Revenue. His argument was that once the enquiry window was past, he was entitled to certainty and the discovery assessments raised later by HMRC were not competent. If his argument was correct, HMRC could not assess the tax on his gain and he would not need to begin the very complex arguments nor provide the detailed information about his life that would be necessary to resolve his tax residence status.

15 years have passed and yet the argument is still about whether HMRC are entitled to assess having discovered that he may not have shed his UK residence status. The Court of Appeal has held that a taxpayer could not establish the right to require a separate trial or any related right under the relevant statutory provisions in relation to matters concerning a discovery assessment.

Also, it held that the tribunals should have discretion to determine whether there should be a separate trial of the issue on which the onus of proof rests with HMRC in the context of such a discovery assessment.

Since the Langham v Veltema decision, the intention and spirit of the original self-assessment law has been frustrated. It was a bad decision but over the years HMRC have dumbed down its staff and HMRC now relies on being able to process now and check later, essentially ignoring the original intention that taxpayers who made full disclosure were entitled to certainty in their tax position by 12 months after the filing date. The original self-assessment legislation was trying to enact the guidance given by the Courts in Scorer v Olin Energy. If I may paraphrase that guidance, a disclosure with sufficient information that the average officer of average experience and ability ought to know what is being claimed should protect such a taxpayer from a discovery assessment. The Veltema decision changed the law. Every tax adviser should now respect the principle that if clients decide to practice avoidance, they should anticipate HMRC challenging and they should be prepared for a long period of uncertainty.

http://www.bailii.org/ew/cases/EWCA/Civ/2016/174.html

2. Income tax thresholds in Scotland

Back in the 1980s I recommended that there was an urgent need to simplify tax and reorder the tax legislation so that amendments could be consolidated. My representations fell on deaf ears and ICTA 1988 was the new consolidated legislation. In my view, our politicians have performed abysmally and in 2015 I understand that we have 22,298 pages of tax law which is supposed to be the framework for a self-assessment regime. It is getting worse. The Finance (no 2) Bill runs to some 179 sections and twenty five schedules over 571 pages.

Politicians crave the oxygen of publicity. Successive Chancellors have tinkered with the system making it ever more complex. That complexity introduces a higher probability of mistakes and it makes tax compliance more expensive. Politicians appear to lack common sense in such matters and without regard to what it will cost business and taxpayers; they cannot resist tinkering with the tax system.

The Scottish Government has announced that income tax rates in Scotland will be frozen, with no increases in the basic, higher or additional rate, and the higher rate threshold frozen in real terms. With computerised payrolls, the administration of such differential rate bands is achievable but there is a cost to employers and to HMRC.

The higher rate threshold will be increased only in line with CPI inflation in 2017/18 from £43,000 to £43,387and by no more than inflation until 2021/22. According to the Scottish Government: ‘By adopting a different path to the UK Government we could generate more than £1 billion of additional revenues….”

If you believe that, I suspect that you also believe in the tooth fairy and think that porcine aviators are everyday occurrences. I think the cost of administering a tax system with different rate thresholds will probably exceed any additional yield. Any additional yield without changing the rates is likely to be negligible and it is not credible that it could be anything like £1bn for Scotland.

The Scottish Rate of Income Tax (SRIT) applying form 6 April 2016 is 10% meaning that the income tax rates applying to the non-savings non-dividend income of Scottish taxpayers are the same of those in the rest of the UK. From 2017/18, the Scottish Parliament will be able to set the rates of income tax and the limits at which these are paid, for the non-savings and non-dividend income of Scottish taxpayers. If they were to increase the basic rate of income tax from the UK level of 20% to say a Scottish level of 25% as well as freezing the rate bands they might generate additional revenues approaching £1bn but I anticipate that this might be politically unpopular and not something the Scottish Government would wish to explain before the elections this year.

3. Car benefits and leased cars used by employees

HMRC should hang its head in shame for its misconduct in pursuing an appeal which offends the spirit of tax law and seeks to tax something as a benefit when there is no benefit to the employee. In HM Revenue & Customs v Apollo Fuels Ltd & Ors & Anor [2016] EWCA Civ 157, The Court of Appeal has ruled that if an employee pays the full open market value for something, then there is no benefit to be taxed.

The central issue on this appeal is whether an employee is liable to income tax in respect of a car leased to him by his employer on arm's length commercial terms, including lease charges at full market value. The Commissioners for HM Revenue & Customs (HMRC) contend that, although the employee does not derive any financial benefit from the lease and pays a full price by way of lease charges, he is nonetheless chargeable to income tax, by reason of Chapter 6 of Part 3 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). The "cash equivalent" of the leased car, calculated in accordance with Chapter 6, is to be treated as part of the employee's earnings chargeable to income tax.

Every employee who has bought a car using savings from earnings should worry about the principle underlying the *Cooper* decision which is summarised in this article. If there were a smell test – this decision would stink. The Cooper decision which is summarised later and similar decisions might explain why HMRC pursued the appeal in Apollo but it does not make it right for HMRC to ignore the spirit of tax law. Employees in the Apollo case would pay for the lease from their after tax income and then HMRC were attempting to impose a deemed tax charge on fictitious income. That is far worse than double taxation and HMRC are guilty of maladministration in pursuing an appeal like this.

Since April 1994, a company car can be charged as a benefit in kind on up to 35% of the list price of the car and its accessories. In many instances because the real cost of the car is able to benefit from discounts, the taxation is punitive because the list price is considerably more that the commercial cost of buying the vehicle. In addition, cars with higher CO^2 emissions face a higher scale benefit charge and if a company car is renewed every three years and has high emissions at 35%, the employee will have been taxed over the three years on more than the vehicle list price (which in turn may be considerably more than the commercial cost actually paid).

In recent years, car manufacturers have achieved amazing improvements in the level of CO^2 emissions so that even quite large vehicles can now operate on very low emissions. The Government, anxious to encourage the use of lower emissions but also anxious to maintain its tax take on company cars has increased the percentage.

In taxation, the legislation which establishes a benefit on an employee who has the private use of a vehicle is intended to be a deterrent. Accordingly, if a car is made available at all to an employee, then, according to HMRC it is automatically deemed to be available for private use unless there is a specific prohibition on private use and there is no private use made of the vehicle during the tax year. If the car is available even if it is not used the tax charge can be imposed.

A number of decisions have shown that HMRC are taking a hard line on the question of being available for private use. The fact that, for example, an employee was unable to use a company car does not mean that the car is not available for private use. So if the employee lost their licence or was unable to drive because of injury, if the car is available a benefit in kind may still be charged.

HMRC argument is often that the vehicle may still be available for the private use of members of the employee's family or household.

A decision before the First-tier Tribunal suggests that HMRC's aggression towards the tax charge on company cars is now going beyond the bounds of common sense.

The law which can be found at section 114 ITEPA 2003 and subsequent sections provides that a company car tax charge will arise if three conditions are met. The first of these conditions is that the car is made available to an employee or a member of the employee's family or household. The second condition is that the car is so available by reason of the employment and this is the issue where HMRC appear to be pushing the boundary of common sense. The third is that the car is available for the employee or household members' private use.

If these conditions are met, the cash equivalent which will be assessed on the employee for the benefit of the car is treated as that employee's earnings (ITEPA 2003, sections 120 to 148).

In *Christensen v Vasili [2004] STC* a director bought a 5% interest in a car which his company provided to him. He argued that this transfer of part of the property in the car gave him rights to use the car. Accordingly, the company car tax charge could not arise. The case went to the High Court, reversing the decision of the Special Commissioner that a tax charge arose under the company car rules. One can see this decision, though perhaps ignoring the director's human rights established by his part ownership of the vehicle, makes sense as 95% of the vehicle was owned and provided by the employer company.

The unacceptable direction of HMRC's aggression in imposing the car benefit appeared in *Whitby & Another [2009] TC 00255.* In this case, an employee leased a car on an arm's length basis. If that employee had leased the car from an independent car leasing company there would not have been any tax charge. However in this instance the employer was a car leasing company. So the car leasing contract was with the employer and it was the employer who bore directly the cost of servicing, insurance, road fund licence etc. for the vehicle.

The employee made rental payments that were the same as would have been made if they were not an employee. So in fact the employee was bearing all the costs and the leasing company would expect to make a profit. Despite this, the individuals were found to be taxable on the company car benefit on the basis that they were driving cars made available to them by their employer.

In strict law HMRC could have ignored the lease rental payments because it was not a requirement that satisfied the test set out in section 144 ITEPA 2003. By concession, HMRC allowed some of the lease rental payments paid by the employee to be treated as if that requirement test was satisfied. This still left the employee facing a massive tax bill for the fuel benefit being assessed over all in-date years and exceeding £74,000.

HMRC have a duty to impose the literal interpretation of taxing statute. In *Stanford Management Services Ltd [2010] TC 00409,* two directors leased Mercedes cars. The lease contracts were in the name of the company but in fact all payments were debited to the directors' loan account. The substance of the transaction was that the directors had leased the cars and paid for them and were in reality the registered keepers but the detail of the contract found that the company had signed the contract for leasing the cars from Mercedes and then provided the cars to the directors. A benefit in kind arose even though the company was not bearing any of the costs. The directors were bearing the costs personally out of their own money.

In *G R Solutions Ltd v Revenue & Customs [2012] UKFTT 234,* it was the director personally who had initially purchased the vehicle and subsequently transferred a 90% interest to the company. Mr Hall, a director of the company bought a BMW X5 costing £53,645. He then transferred 90% to the company for £48,636 arguing that his 10% share which approximated to his annual private mileage meant that the company was not making the car available to him. This argument was rejected with the court finding that the company was liable to pay class 1A national insurance contributions in respect of car and fuel benefit totalling £19,726. Mr Hall's argument that the car was available to him by virtue of his ownership rights and contribution towards running expenses prevented the fiscal fiction of car benefit rules applying was rejected.

HMRC's argument was that when the employee uses the car for private purposes the employer's 90% share of the car is being made available to the employee at that time and it is so made available by reason of his employment.

The 2012 development has emerged with the decision of *Cooper & Others (Leaside Timber and Builder Merchants Ltd) v Revenue & Customs [2012] UK FTT 439.* In this case, a parallel service partnership was funded in part by the partners contributing capital which enabled this partnership to buy cars. The sole income of the service partnership derived from the trading company. The service partnership charged a management fee for the services provided by the partners and three employees. The sole customer of the partnership was the limited company.

The partnership provided cars and the overhead expenses including fuel to each of the partners. Each partner faced a disallowance for the private use that they made of the vehicle and its associated running expenses but HMRC went a stage further and said that as two of the partners were directors of the building company the provision of the cars came from the directors' employment. This seems to be taking the fiscal fiction created by the car benefits legislation to an unacceptable extreme. The consequence produces substantial amounts of tax because the company owed class 1A National Insurance of around £70,000 and the individuals faced a tax bill of around £145,000.

The Tribunal confirmed that the partnership is independent from the company and carries on its own account to commercial business but that business is wholly dependent upon the company, its sole customer. The Tribunal took the view that the management fee paid by the company to the partnership was more generous than would pertain if independent parties were acting at arm's length. With this in mind, the Tribunal found as a fact that the management charges comprised some of the running costs and depreciation for the cars and so argued that the company made available the cars to the directors for private use.

This is of course an outrageous outcome but it shows that in applying the strict letter of the law taxation can be very unfair. The directors have been charged in part by a disallowance in the computation of the partnership profit for their private use but they now face a double charge under the benefits in kind legislation because the Tribunal has interpreted the words *"by reason of his employment"* as much wider than common sense would suggest. In this case, even though the cars were bought and paid for by a partnership which is quite separate from the company, the argument is that all of the costs of providing and fuelling the cars were being met by the company through the management charge that the company paid to the parallel service company.

This Cooper decision has the potential to affect commercial arrangements which have been put in place. A key finding of the Tribunal is that the fees paid by the company to the partnership were excessive if one applies a test of what would be commercially reasonable in dealings between independent parties acting at arm's length. The Tribunal concluded that the cars in question were made available and the car fuel provided to each of the individuals by reason of their employment by the company. Even though the individuals were meeting all of the costs of the vehicles from what was their own money, the Tribunal concluded that there is no basis for reducing the cash equivalent of the benefits received by the partners.

Members of a trading partnership which derives income from a trading company in which an individual partner or partners has a material interest need to take note of this decision. If you think you are affected, you should seek advice, as a matter of urgency, from an experienced tax adviser.

In principle, all employees who have saved their wages to buy and run a car could find themselves facing another tax cost on a car benefit. It won't happen if common sense prevails.

The Tribunal has decided in favour of HMRC but in so doing they have illustrated that the interpretation of the car benefits legislation has gone beyond what can be acceptable. To be taxed on a fictitious "*benefit"* that was paid for using your own hard earned money is absurd.

Fortunately, this decision has been restricted and clarified by the Court of Appeal decision in Apollo Fuels. David Richards LJ, who gave the only substantive judgment, said that a charge to income tax arises under Chapter 6 only if the terms on which a car is leased to an employee confer a 'benefit' on the employee in the ordinary sense of that word. As the employees had leased the cars on arm's length terms and paid full market value they had received no benefit. Lady Justice Sharp and Sales LJ agreed. Thank goodness that common sense prevailed.

http://www.bailii.org/ew/cases/EWCA/Civ/2016/157.html

4. Finance Bill progress and Royal Assent

Financial Secretary to the Treasury David Gauke has indicated that the Committee Stage of the Finance Bill will not start until after the EU referendum. The bill runs to 571 pages of additional legislation and deserves proper consideration, but the delayed start means that responsible politicians may need to take more time considering the clauses.

The normal practice when considering Finance Bills is to get the Bill enacted with Royal Assent before parliament recesses but with this delay for the referendum this may be doubtful. The House rises for the summer recess on 21 July 2016. Personally, I think it would be in the public interest for the Bill to be considered properly but this might mean that Royal assent is delayed until Parliament resumes after the summer recess in October 2016.

5. Treasury analysis of EU choices for UK

I used to respect the impartiality of the UK civil service and I believed that Government information was reliable. I must declare that my faith in government statistics and research has diminished in recent years.

According to the UK Treasury, Britain will be worse off by £4,300 a year per household if Britain votes to leave European Union.

HM Treasury's analysis has considered the three existing alternatives:

- membership of the European Economic Area (EEA), like Norway
- a negotiated bilateral agreement, such as that between the EU and Switzerland, Turkey or Canada
- World Trade Organization (WTO) membership without any form of specific agreement with the EU - like Russia or Brazil

The central estimates – defined as the middle point between both ends of the range – for the annual loss of GDP per household under the three alternatives after 15 years are:

- £2,600 in the case of membership of the European Economic area, like Norway
- £4,300 in the case of a negotiated bilateral agreement like Switzerland, Turkey or Canada
- £5,200 in the case of membership of the World Trade Organisation (like Russia or Brazil)

The analysis also finds that the negative impact on the economy (GDP) would result in a total reduction in tax receipts of £36 billion, equivalent to around an 8p increase in the basic rate of income tax and that the negative impact on the economy would result in substantially weaker tax receipts.

This would significantly outweigh any potential gain if we were to make lower financial contribution to the EU - which are a little over 1p for every £1 of tax paid once the UK's rebates and receipts are taken into account.

HM Treasury estimates that the total reduction in tax receipts under each scenario would be as follows:

- £20 billion in the case of European Economic Area membership, like Norway
- £36 billion in the case of a negotiated bilateral agreement, like Switzerland, Turkey or Canada
- £45 billion in the case of World Trade Organisation membership, like Russia or Brazil

A reduction of £36 billion in tax receipts would result in higher government borrowing, large tax rises or major cuts in public spending.

https://www.gov.uk/government/news/eu-referendum-treasury-analysis-key-facts

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There will be a general tax podcast updating AAT members on recent developments and decisions available on the website on 31 May 2016.