CAPS TECHNICALBULLETIN

ERRATUM – ISSUE 136

In the article entitled "Rental Income Changes – Landlords Under Attack" in this issue, we incorrectly stated at page 5 that the 3% Land and Buildings Transaction Tax ("LBTT") supplement on properties costing over £40,000 does not apply to companies. The LBTT supplement will apply to all purchases of residential properties by companies and other such "non-natural persons", whether or not they already own a residential property.

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CAPS TECHNICAL BULLETIN

ISSUE No 136
FEBRUARY 2016

RENTAL INCOME CHANGES – LANDLORDS UNDER ATTACK

A great deal has happened over the past few months to make life tougher for residential landlords. The list of issues now includes an additional 3% of LBTT (or SDLT in England and Wales) on second homes and buy to lets from April 2016; the abolition of the wear and tear allowance from April 2016, and a new renewals basis; the restriction of relief on finance costs for residential property letting from April 2017; faster payment of Capital Gains Tax (CGT) from April 2019, with only 30 days from disposal to pay tax on account; HM Revenue & Customs' (HMRC) property campaign and taskforce specifically targeting landlords; and growing uncertainty around the status of landlords as 'businesses' for CGT and National Insurance purposes. All this puts timely advice for landlords at the top of the list. The information they need, and what you need from them and when, is going to change. With difficult decisions ahead, accurate advice will be needed.

Finance costs on residential property

Looking ahead to April 2017, the tax relief on finance costs incurred by landlords of residential property will be restricted to basic rate. The impact is likely to be much wider and deeper than might first appear. It would be worth reviewing all individual, partnership and trust residential landlord clients, as the additional tax costs could render some property businesses uneconomic, and the additional Land and Buildings Transaction Tax (LBTT) on second homes and buy to let properties may mean that exit routes in terms of selling unwanted rental properties could be restricted.

Key points to note on the restriction of tax relief on finance costs are that it is to be phased in from April 2017, and will be fully in place by 2020/21; it operates by disallowing all the finance costs and then permitting a deduction from overall tax liability equivalent to basic rate tax relief on the finance costs, which means that landlords who currently pay at basic rate may become higher rate taxpayers, and taxable income is increased, so landlords may suffer higher tax charges as a result of the High Income Child Benefit Charge (where income is around the £50,000 mark) and reduction of personal allowances (where income is around £100,000); it does not apply to property owned by a company, and while there are significant barriers to incorporating existing property businesses, trading via a property company is an option now worth considering; and it applies to the incidental costs of obtaining finance, such as arrangement fees, as well as the loan interest.

Where to find the rules

The Finance (No 2) Act 2015, section 24, introduced the changes. The details can be found in newly inserted sections 272A and B, s 274A, and s399A and B of Income Tax (Trading and Other Income) Act 2005 ("ITTOIA").

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Dwelling house or commercial letting?

The restriction applies to a property business carried on for the purpose of generating income from either "*land consisting of a dwelling-house or part of a dwelling-house, or an estate, interest or right in or over land consisting of a dwelling-house or part of a dwelling-house*". "Dwelling house" takes its everyday meaning. Furnished holiday lets and commercial lets are excluded, but not overseas residential lets. Apportionment of costs, on a just and reasonable basis, will be needed where there is mixed commercial and domestic property, such as a flat over a shop.

Looking at the arithmetic

The change is being phased in from 2017/18 and will be fully effective from 2020/21. The deductibility of finance costs decreases by 25% each year, while the basic rate deduction is phased in by 25% each year. See Table 1 for an example.

Don't forget the National Insurance, or the CGT

Income from a rental business is normally treated as unearned income. This can be a two-edged sword. Sometimes individuals with a significant rental business, which is a full-time activity, may wish to pay National Insurance to gain state benefit and pension rights, but will the rules allow this? On the other hand, individuals running a property business may not wish to bear the cost of National Insurance in addition to income tax. It is important to be clear about which side of the line your client wants to be, and whether their involvement in the business supports that position?

Business or not?

The situation is not made any easier by the fact that sometimes taxpayers with letting property may want to claim relief from capital taxes on the basis of running a 'property business'. For example, in the case of Mrs Ramsey

Table 1

Example – based on 2017/18

	£	£
Property income (residential letting)		45,000
Less: Allowable property expenses		(6,500)
Finance costs	10,000	
Restriction in finance costs (disallow 25%)	2,500	
Permitted deduction for finance costs		(7,500)
Net property profit		31,000
Other taxable income		20,000
Total taxable income		51,000
		======

	£	£
Tax due:		
Taxable income		51,000
Personal Allowance		11,000
		40,000
		======
At 20% to £32,000	6,400	
At 40% on £8,000 (40,000 – 32,000)	3,200	
	9,600	
Less: Basic rate relief on 25% of finance costs £2,500 x 20%	500	
Tax payable	£9,100	
	=====	

Note:

1. Taxable income is now £51,000 so High Income Child Benefit Charge (HICBC) could apply. On the same figures in 2016/17, with full deduction for interest, taxable income would have been £2,500 less, at £48,500.
2. Where finance costs are significant, the impact by 2020/21 could be dramatic.
3. s274A, which sets out the tax reduction rules, makes some further restrictions to the relief available. Relief cannot exceed 'adjusted total income' for the year – which is total taxable income less savings and dividend income and after deduction of personal allowance. In some cases, unused relief will have to be carried forward.

How the restriction will be phased in:

	2016/17	2017/18	2018/19	2019/20	2020/21
% of finance costs deductible	100%	75%	50%	25%	0%
Basic rate relief deduction given as % of finance costs	0%	25%	50%	75%	100%

in **Ramsay v Revenue and Customs Commissioners [2013] UKUT 0226 (TCC)**, the question was whether Mrs Ramsey was carrying on a business as going concern for purposes of roll-over relief under s162 of the Taxation of Chargeable Gains Tax Act 1992. Having lost at the First Tier Tax Tribunal, Mrs Ramsey's appeal to the Upper Tribunal was successful and the activity was judged to be a business, though it is likely that every case will turn on specific details. In the Ramsey case, the judge considered whether the taxpayer's activities were a 'serious undertaking earnestly pursued' or a 'serious occupation'. It must also be noted that the criteria defining a business for s162 purposes differ from those for National Insurance.

The National Insurance hurdle

The Social Security Contributions and Benefits Act 1992, s2 sets out the categories of 'earners' who are liable (or eligible) to pay National Insurance. Section 2(1)(b) defines a self-employed earner as "*a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment)*". The Gov.uk site has reduced this to "*You'll also have to pay Class 2 National Insurance if what you do counts as running a property business, eg if all of the following apply: (1) being a landlord is your main job; (2) you rent out more than one property; and (3) you're buying new properties to rent out*". This could well cause confusion for clients as 'carrying out the normal tasks of landlord' would not normally be sufficient to count as a property business for National Insurance.

Level of activity

There is much anecdotal evidence, based on HMRCs' challenges in individual cases, which can give a indication of the boundary, but provide no precedent.

One case which came before the Special Commissioners, **Rashid v Garcia (Status Inspector) - [2003] STC (SCD) 36**, concerned an individual, Mr Rashid, who wanted to pay National Insurance in order to qualify for state benefits. His right to pay National Insurance was rejected. His level of involvement in the property business was recorded in detail. In overview, it comprised resolving tenants' problems, cleaning shared areas, garden maintenance, drawing up tenancy agreements, collecting rents and carrying out inspections. Due to ill-health, his work was limited to 2-4 hours a week, but family members carried out another 16-14 hours a week. Interestingly it was agreed that work carried out by members of his family could be attributed to him, as they were working as his agents. Yet all this was insufficient to constitute gainful employment.

HMRC's view is set out in the National Insurance Manual at page 23800 which can be found at: **http://www.hmrc.gov.uk/manuals/nimmanual/nim23800.htm**. It states that the type of activities would need to go beyond those normally attaching to being a landlord of a single property, before National Insurance becomes payable. Activities don't need to equate to a 'trade', but would be expected to be on a significant scale, for example multiple properties and full-time work, with a commercial aim of expanding the business.

HMRC gives a number of examples, but the distinctions are quite fine: ten properties let out to students by a 'full-time' landlord is a business; whereas buy-to-lets run via a property agent are not. The distinctions become particularly fine where there are ancillary services, such as meals or a laundry service (eg for students). At one end of the scale, such an arrangement can come under the rent-a-room scheme (with an updated £7,500 limit from April 2016), while at the other they may amount to trading as a guest house.

Capital Gains Tax

As announced in the Autumn Statement, from April 2019 a payment on account will be required within 30 days of the completion of the disposal of residential property, unless full private residence relief applies. Draft legislation is expected in 2016. This could have significant cash flow implications for buy to let landlords who have previously been able to wait until the 31 January Self Assessment filing deadline, almost ten months after the tax year end, before paying the tax.

Clients wanting to exit the rental market face a further barrier. The measure will also affect properties which have not continuously been occupied as a main private residence – such as those which attract CGT private residence letting relief. It may be necessary to prepare computations at the time of sale to show if CGT is due now, rather than include this in the usual Self Assessment tax return schedule. In this context it is worth remembering changes to the main private residence election rules, and the change on disposals of UK residential property interests by non-residents, which were introduced by the Finance Act 2015.

Renewals, repairs and residential lets

April 2016 sees the introduction of a statutory renewals basis for property businesses as announced in the Autumn Statement, with legislation expected in the Finance Bill 2016. It follows a Consultation which ran from July to October 2015.

The Autumn Statement announcement ends a period of uncertainty, particularly on the question of tax relief for white goods in unfurnished or partly furnished accommodation. According to the Autumn Statement, the new relief will cover furnishings, white goods and kitchenware for use by the tenant. Like for like replacements will be deductible in full, but no relief will be given for the initial costs of furnishing/equipping the property. Where there is an element of improvement, the deduction will be limited to what substantially the same asset would have cost.

In practical terms this still leaves some questions unanswered. We could find ourselves back in the hair splitting "capital or revenue expenditure, fixtures or free-standing furnishings, enhancement or replacement" debate.

Implications for landlords

A survey of landlords by ICAEW and CIOT showed that around 75% of landlords are unaware of the impact of the withdrawal of the non-statutory renewals basis in April 2013. So landlords are likely to need significant advice on what expenditure is deductible, and in what circumstances. This is particularly relevant for landlords of unfurnished or partly furnished residential property, as it may be more tax efficient for many landlords to delay any replacement expenditure until the new rules come in this April. The deduction will not be available for furnished holiday lettings (capital allowances may be available) or if rent-a-room relief is claimed in respect of the dwelling-house.

Timeline of the changes

April 2011 - a statutory 10% wear and tear allowance election introduced (s308A – s308C ITTOIA 2005) applying for furnished residential lets only.

April 2013 - non-statutory renewals basis withdrawn by HMRC.

As part of the process of putting HMRC concessions onto a statutory basis, ESC B1 (Machinery or plant: changes from "renewals" basis to capital allowances basis) and ESC B47 (Furnished lettings of dwelling houses: wear and tear of furniture) were withdrawn.

A good summary of the 'old position' can be found in the HMRC Property Income Manual page PIM3230 which can be found at: **http://www.hmrc.gov.uk/manuals/pimmanual/PIM3230.htm**.

Though ESC B47 was, strictly speaking for furnished lettings, the non-statutory relief, by concession, permitted a deduction for expenditure on furniture and furnishings for unfurnished and partly furnished accommodation. No allowance was given for the initial costs, but replacements were tax deductible in full.

Cutlery and other small items may be deductible under S68 ITTOIA 2005, though not white goods (see HMRC guidance at BIM46960 which can be found at: **http://www.hmrc.gov.uk/manuals/bimmanual/bim46960.htm**).

From 2013/14, tax relief for fittings and white goods in unfurnished and partly furnished residential lets is in limbo. HMRC's view is that no deduction is permitted for furnishings or white goods, except for the statutory wear and tear allowance permitted only for furnished lets. So expenditure on such items for unfurnished or partly furnished lets would not be deductible. This would appear to be an unintentional consequence of the withdrawal of the concessions.

From a practical point of view there are two questions:

Firstly "*what can be covered under S68 ITTOIA 2005?*" S68 is about replacement and alteration of trade tools. It says that where expenses are incurred on replacing or altering any tool used for the purposes of a trade, and a deduction for the expenses would not otherwise be allowable in calculating the profits of the trade because (and only because) they are items of a capital nature, then in calculating the profits of the trade, a deduction is allowed for the expenses. In this context, a "tool" means any implement, utensil or article. So, if the property business amounts to a trade, and the articles are 'tools', a deduction may be possible.

Secondly "*What can count as repairs?*" The issue here is that repairs may be deductible on the normal 'wholly and exclusively rule'. So repairs to furnishings and equipment are an allowable deduction as they are the 'replacement' of fixtures which form part of a larger entity. This can be a tricky line to draw. HMRC has examples at BIM46910 (**http://www.hmrc.gov.uk/manuals/bimmanual/BIM46910.htm**), PIM2020 (**http://www.hmrc.gov.uk/manuals/pimmanual/pim2020.htm**) and BIM46900 (**http://www.hmrc.gov.uk/manuals/bimmanual/BIM46900.htm**).

April 2016 – the statutory renewals basis will be introduced for all residential lettings. Statutory 10% wear and tear allowance for furnished lettings will be withdrawn. From April 2016, furnished and unfurnished lettings are treated the same. There is no 10% wear and tear allowance, and replacements can be deducted in full.

Let property campaign

Part of HMRC's compliance strategy is campaigns. Some are of relatively short duration, while others are more open ended. In addition to campaigns, there are taskforces. While campaigns invite taxpayers to comply, taskforces actively look for defaulters, usually in a specific geographical area, and sanctions are likely to be high, including prosecution. With let property, there is both a taskforce and a campaign. In view of all the changes, now would be a good time to review client's affairs for possible errors – and consider voluntary disclosure via the campaign, rather than risk high level intervention by a taskforce.

What to look out for

One of the biggest risks are the things which your client has not told you about. In a property context these could include treating rental income, particularly in a family context, as the income of one person when, by the Taxes Acts, it should be treated differently. For example, watch out for the jointly held property rules of Income Tax Act 2007, s836. For married couples and civil partners, statute imposes a 50:50 split of rental income, with limited exceptions (such as furnished holiday lettings). Different income allocations need to be justified on the facts and an election made on Form 17 (see **https://www.gov.uk/government/publications/income-tax-declaration-of-beneficial-interests-in-joint-property-and-income-17**). Sometimes clients will pay the rent into a bank account in one spouse's name, where the property is actually owned in joint names.

Another risk is assuming that income is covered by the rent-a-room scheme and does not need to be disclosed. For example, clients with children who are students may purchase a property for them to occupy while at university, which is let out to other rent paying students. But is the property the student's main residence? If the student's main home is still with their parents, then rent-a-room won't apply to the student house. You should also ask "*Is anyone else getting letting income from lodgers from the property?*" The rent-a-room limit is halved where more than one person receive income from the same property, even if the other people do not qualify for rent-a-room relief. Oddly, this rule means that if there are three or more people eligible to rent-a-room on the same property, then the total relief claimed can exceed the usual annual limit; with three people the limit is three halves of the annual limit.

Finally, has your client told you about any overseas properties? A common error is that this is omitted on the basis that the client assumes that paying tax abroad is sufficient. Special rules apply for Foreign Tax Credit Relief. In particular, the maximum relief is usually restricted to the amount of tax which ought to have been paid on the overseas income, even if the amount actually suffered is more.

Are changes in time?

If any errors are found, remember that Self Assessment returns can be amended within 12 months of the usual 31 January filing date for the return. Correcting errors in this way avoids the need for disclosure under the campaign.

More details

There is more information about the let property campaign at: **https://www.gov.uk/government/publications/let-property-campaign-your-guide-to-making-a-disclosure/let-property-campaign-your-guide-to-making-a-disclosure**. The HMRC property rental toolkit addresses common errors and can be found at: **https://www.gov.uk/government/publications/hmrc-property-rental-toolkit**.

Land and buildings transaction tax

With George Osborne's 3% premium on SDLT for second homes and buy to lets, announced in the Autumn Statement, it was hardly unexpected that John Swinney would act to align the position across the UK. The Scottish Budget announcement made it clear that a 3% supplement would apply for LBTT too. While there will be a period of consultation before the rules are finalised, with an April 2016 proposed commencement date, this will of necessity be of limited extent and duration.

The key points to note are that the measure does not apply to companies, and there is no 3% supplement where the total purchase price is £40,000 or under. However, for a property over £40,000, the supplement applies to the whole of the purchase price, not just the amount above £40,000. (see Table 2 above)

Table 2

Band	Normal LBTT rate	Total including 3% additional homes supplement
0 - £40,000	0%	0%*
£40,001 up to £145,000	0%	3%
£145,001 to £250,000	2%	5%
£250,001 to £325,000	5%	8%
£325,001 to £750,000	10%	13%
£750,001 and above	12%	15%

*Where the total purchase price is £40,000 or under, there will be no additional homes supplement surcharge; but where the total purchase price is over £40,000, then the 3% supplement will apply to the entire 0 - £145,000 band. This is deliberately different from the usual LBTT position where the entire 0 - £145,000 band is charged at 0% even where the total house price exceeds £145,000.

Scotland's Spending Plans and Draft Budget 2016/17 estimates that the surcharge will raise between £17 million and £29 million in 2016/17.

MORE AUTUMNAL THOUGHTS

Following the Chancellor's Autumn Statement, the draft 2016 Finance Bill has been published.

National Insurance for the self-employed

The Summer Budget announced a change to National Insurance contributions payable by the self-employed, with the abolition of Class 2 contributions and a reform of Class 4 contributions. A consultation document has been published and the proposals are that:

- There is to be a new zero rate band in respect of Class 4 which will apply to profits up to the Lower Profits Limit, which is currently £8,060 per annum.
- The contribution conditions for state pensions and other benefits are to be amended so that Class 4 NIC will now count where annual profits are at the level of the Small Profits Threshold (currently £5,965). It will therefore be possible for individuals with low profits, paying Class 4 NIC at the zero rate, to qualify for state benefits while paying no contributions. This will be similar to the position with Class 1 NIC payable by some employees and directors with low earnings.
- The level of the Small Profits Threshold is to be aligned with the Class 1 NIC Lower Earnings Limit which applies to employees contributions. The Small Profits Threshold will be 52 times the amount of the weekly Lower Earnings Limit.

The abolition of Class 2 NIC will be a simplification, but the greater simplification will be when the Government takes the courageous step of abolishing National Insurance altogether and merging it with income tax. It seems that the only group of people who believe that National Insurance is not a tax work within the Palace of Westminster.

Extracting funds as a capital gain

A number of changes are proposed with effect from from 6 April 2016 in connection with company distributions and, in particular, extracting funds from a company by way of a capital gain and qualifying for the 10% entrepreneurs' relief rate. The proposals are aimed at the following:

- Where a company has taken a decision to accumulate profits and cash to avoid the Income Tax liabilities which would arise on the payment of dividends to individual shareholders, the capital distributions to shareholders could be taxed as income. On a members' voluntary liquidation, companies and their shareholders may have to justify the position taken along similar lines to those in Inheritance Tax cases where HMRC take the view that not all of the value of a shareholding qualifies for Business Property Relief because of surplus cash not required for the trade.
- The normal liquidation of a company does not invoke the transactions in securities rules. However, it is proposed that where there is a liquidation with the shareholders being involved in a similar trade within two years, the distributions on liquidation are to be treated as income.
- A similar position will result where activities are divided between a number of companies with each being liquidated at separate times over a period. Where a shareholder has a continuing involvement in a similar trade within two years of the winding up, distributions will be treated as income where there is a main purpose of obtaining a tax advantage. Provisions are to be introduced to take account of an individual's associates and connected persons. For example, if a spouse or child sets up a new company to carry on an activity when an individual had put a company into liquidation within the previous two years, then this is likely to be caught.
- Where there is more than one company, the reserves taken into account will be those of the whole group.
- For capital treatment to apply where a company purchases its own shares, amongst other requirements, it is necessary for two mechanical tests to be met. Firstly, after the purchase, the vendor cannot be "connected with" the company which basically means that he cannot continue to hold more than 30% of the share capital. Secondly, the vendor's shareholding percentage after the purchase cannot be more than 75% of his shareholding percentage prior to the purchase. There may be changes to these two arithmetical tests.
- There is talk of the close company apportionment provisions being reintroduced to encourage payment of dividends. For those of you who are not old enough to remember these provisions, if a company did not pay dividends at a high enough level, shareholders were deemed to have received a dividend and suffered income tax anyway, albeit that it was the company which paid the liability. Forward to the past, it would seem. The Government is in the interesting position of running with the hare and hunting with the hounds, in that it doesn't seem to like close companies remunerating shareholder/directors by way of dividend, but it doesn't seem to like it if those same individuals don't pay themselves what they consider to be enough dividends either!

None of these proposals will simplify matters for companies nor make things any more certain. They will just add to an already voluminous and unclear morass of tax legislation which sadly is swamping the UK.

More anti-avoidance measures

There are also proposals to further crack down on tax avoidance schemes. Among the anti-avoidance and enforcement measures are draft clauses to penalise "serial avoiders". HMRC will issue a notice to a tax payer when a tax scheme fails and this will have a number of consequences.

- Each year during the five years following such a notice, the taxpayer must notify HMRC confirming whether or not they have taken part in another avoidance scheme and, if identifying it if they have.
- There are additional penalties, based on the amount of tax saved, for using a scheme which fails in the five year period. The penalties range from 20% to 60%.
- Additionally, HMRC can publish the names of taxpayers who use three such avoidance schemes within the five year period.
- There will also be the ability to restrict tax reliefs where the tax payer has used three schemes which have failed in the period.

The legislation uses the term 'defeated' for a scheme failure and this term is defined as:

- Where a counteraction notice is issued and becomes final under the General Anti Abuse Rule.
- Following the issue of a 'follower notice', the individual's tax position becomes final where a scheme has been notified under the Disclosure of Tax Avoidance Schemes rules and the individual's self assessment is amended and finalised with the tax advantage being cancelled.

These provisions will come into effect after 5 April 2017. However, they will also catch situations where tax schemes have been used prior to Royal Assent and which are 'defeated' after 5 April 2017, as warning notices will be issued in these circumstances. No warning notice will be issued if the taxpayer confirms to HMRC by 5 April 2017 that he has withdrawn from the scheme.

So it would seem that the Government steamroller continues on its road to flatten 'customers' who, in their view, aren't paying the 'right amount of tax'.

LEGITIMATE EXPECTATION: CAN YOU RELY ON HMRC GUIDANCE?

Although UK tax legislation is enacted by Parliament, HM Revenue & Customs (HMRC) need to exercise some discretion in collecting and managing taxes. In doing so they issue statements including statutory clearances, non-statutory clearances and assurances given to particular taxpayers or representative bodies, and they publish other material in the form of extra statutory concessions, statements of practice, internal manuals, guidance notes, tax guides, briefing notes and bulletins.

Where HMRC's statements or guidance mislead a taxpayer to his detriment, he may have a 'legitimate expectation' that HMRC will treat him in a certain way and is protected by the courts on the basis that the principles of fairness, proportionality, predictability and certainty should not be disregarded.

Mansworth v Jelley

Some tax litigation seems to have almost endless reverberations. **Mansworth v Jelley [2002] EWCA Civ** (**http://www.bailii.org/ew/cases/EWCA/Civ/2002/1829.html**) was such a case. It concerned unapproved share options granted to the taxpayer in the early 1980s, exercised in 1989 and 1991, with the resulting shares being sold shortly afterwards.

The point at issue was how the taxpayer's acquisition cost was to be computed for capital gains tax purposes. Was it to be taken as the market value of the shares at the time of acquisition, as the taxpayer claimed, or was it the market value of the option at the time it was granted, plus the consideration paid on exercise of the option, as the then Inland Revenue contended?

The Revenue lost before the General Commissioners, and again in December 2002 at the Court of Appeal. There was a flurry of activity as other taxpayers, relying on this judgment, submitted capital loss claims. The Government then changed the law from 10 April 2003 so that, for all options exercised on or after that date, the arguments that the Revenue had advanced would prevail.

Revenue guidance published in 2003 confirmed that pre-10 April 2003 **Mansworth v Jelley** type losses would be allowed. Then in 2009 HMRC changed their guidance, saying that any claims still remaining open for such losses would not be allowed. In 2013 HMRC decided to use their collection and management powers to allow relief for such losses to the extent that taxpayers could show that, on the balance of probabilities, they'd relied on the 2003 guidance to their detriment and legitimate expectation could have been demonstrated at the time, even if it could no longer be demonstrated because of delay.

This is still relevant to many taxpayers because capital losses, by their nature, can be carried forward and may not be used for many years.

Legitimate expectation examined

The principles of legitimate expectation in tax matters have been the focus of much attention since **Mansworth v Jelley**. The matter has been considered in some detail very recently, in a High Court judgment on 11 November 2015 on an application for judicial review in **R (oao Hely-Hutchinson) v HMRC [2015] EWHC 3261 (Admin)** (**http://www.taxchambers.com/wp-content/uploads/2015/11/Hely-Hutchinson-v-HMRC.pdf**)

This case concerned HMRC's rejection of the taxpayer's claim for **Mansworth v Jelley** type losses for the fiscal years ended 5 April 1999 to 2002 inclusive. He asserted a legitimate expectation to claim those capital losses, based on the Revenue's 2003 guidance, and he contended that his claim shouldn't be frustrated by HMRC's revision of their guidance in 2009. He also complained that HMRC had discriminated against him without justification, because they'd agreed many other **Mansworth v Jelley** loss claims and repaid tax in those claims without opening enquiries.

Delivering her judgment, Mrs Justice Whipple recognised established authorities supporting the general principle that HMRC should be held to their published statements – because the publication of those statements is in the public interest, provides certainty amongst taxpayers, is part of the cooperative relationship between HMRC and the public, and is ultimately part of HMRC's tax collection function.

She concluded that HMRC were required to consider whether it was fair to taxpayers to withdraw the 2003 guidance. This placed HMRC under an obligation to perform a 'balancing exercise', weighing taxpayers' legitimate expectations from the 2003 guidance, and the consequent unfairness of withdrawing it in 2009, against the public interest in collecting the tax due under the statute as HMRC now interpreted it.

The Court held that legitimate expectation on the part of the taxpayer had been established, and that HMRC had failed to consider other aspects of unfairness claimed by the taxpayer. The case was remitted to HMRC to make a fresh decision, taking into account all aspects of unfairness.

Legitimate expectation may apply across all taxes, but some claims based on the concept have failed. **HMRC v Noor** in 2013 was one such case, where the First-tier Tribunal held that the taxpayer had legitimate expectation that certain VAT should be repaid but, on appeal, the Upper Tribunal concluded that the First-tier Tribunal had exceeded its jurisdiction.

Wider implications

While **Mansworth v Jelley** has provided a useful testing ground for legitimate expectation, it would be wrong to regard the concept as restricted to such cases. The principles of legitimate expectation in tax law are well established by case law and rehearsed in the **Hely-Hutchinson** judgment.

In **R v Board of Inland Revenue, ex p MFK Underwriting Agencies Ltd [1990] 1 All ER 91** in 1990, Bingham LJ said: "*No doubt a statement formally published by the Inland Revenue to the world might safely be regarded as binding, subject to its terms, in any case falling clearly within them.*"

In **R (oao Davies and Gaines-Cooper) v HMRC [2011] UKSC 47** in 2011, Lord Wilson was more specific when he clarified that a "*statement formally published … to the world*" must also be clear, unambiguous and devoid of relevant qualification in order to give rise to a substantive legitimate expectation of particular tax treatment.

A taxpayer's legitimate expectation to be treated in a particular way can be frustrated if there is an overriding public interest in imposing different treatment, and Lindsay J summarised it thus in **R (oao Bamber) v HMRC [2005] EWHC 3221 (Admin)** in 2005: "*Where there is a substantial public interest in the public body behaving as it has done or as it intends to do then, absent the marked degree of unfairness or of disproportionality illustrated by the cases, relief of the character of judicial review against the public body can properly be and is, indeed, likely to be, withheld.*"

The degree of 'unfairness' or 'disproportionality' must be demonstrably very high if judicial review is to be granted. In other words, the proposed departure from earlier assurances must be so unfair as to constitute an abuse of HMRC's powers. The decision must be so outrageously unfair that it should not be allowed to stand.

Accordingly, there is a need to carry out a 'balancing exercise' at the point where a legitimate expectation has been identified, to determine whether there is an overriding public interest.

EMPLOYMENT CORNER - AUTUMN STATEMENT UPDATE

This Employment Corner contains a round-up of employment related elements from the 2015 Autumn Statement.

Apprenticeship levy

As a result of the 2015 Summer Budget announcement (paragraph 3.56), from April 2017, large employers across the UK will be asked to pay a levy of 0.5% of their payroll costs, collected through PAYE. The total payroll cost on which the levy is to be charged does not include the value of benefits in kind.

At the current levy rate, only those employers with a payroll cost exceeding £3,000,000 will have to pay the levy. In England, the apprenticeship levy will be used to fund apprentice training needs via approved training providers. In Scotland, Wales and Northern Ireland, training and skills is a devolved matter and different rules may therefore apply. Scottish employers should await further advice from the Scottish Government and the department for Business, Innovation and Skills.

The relevant legislation will be brought in under Finance Bill 2016.

AE Minimum contributions

All employers will have to automatically enrol their employees into a pension from 1 April 2017. The Autumn Statement (paragraph 1.137) stated that the scheduled rises in minimum rates of contributions will be delayed until April 2018 and April 2019.

Diesel company cars

Paragraph 3.66 of the Autumn Statement confirms that the 3% diesel supplement for company cars running on diesel will remain until April 2021 - it was due to be abolished in 2016/17. Clients should be aware of this when preparing forms P11D.

Travelling and subsistence tax relief - Intermediaries

The proposals originally launched by the Government on the restriction of tax relief for workers engaged through any type of intermediary (ie one man limited companies, umbrella companies and agencies) if they are under the supervision, direction or control of the engager have been modified by paragraph 3.20 of the Autumn Statement to restrict tax relief only for those workers who provide their work through an intermediary (ie IR35) from April 2016. Other types of engagement through intermediaries will continue to attract full tax relief - for the time being at least.

Employment related securities

Paragraph 3.24 of the Autumn Statement states that Finance Bill 2016 will introduce simplified regulations covering the payment of employment related securities under both tax-advantaged and non tax-advantaged schemes, resulting in any future charges to tax arising under options rules rather than being treated as earnings.

Student loans

Student loans are changing under paragraphs 3.117 to 3.121 of the Autumn Statement. The range of students who will become eligible to apply is widened - which means that students who are in work will need to confirm with their employer that they are in a loan repayment situation. The start dates for this are yet to be confirmed. The new rules also encompass students who are retraining by undertaking a second degree from 2017/18 as well as anyone under 60 years old who wishes to study for a Post-Graduate Master's degree from 2016/17.

Tax-free childcare

Paragraph 1.160 of the Autumn Statement introduces additional changes to the new tax free childcare scheme which will launch in 2017. Existing childcare and childcare voucher schemes will close to new entrants once the new scheme is underway, but it should be noted that workplace nurseries and creches will still be totally exempt, as before.

The changes are that the maximum income level per parent is to be reduced from £150K to £100K, and the weekly income threshold for parents to be eligible is increased from 8 hours at National Minimum Wage to 16 hours at National Living Wage.

WAIVE WITH CAUTION

Despite the Summer Budget announcement that income tax liabilities on dividends will rise by 7.5% from 6 April 2016, it will generally still be advantageous for owner/managers of businesses to remunerate themselves by way of dividends rather than salary.

Over the years, the tax savings from payment and receipt of dividends compared to salary or bonus have not gone unnoticed by companies, but there are sometimes unwelcome complications in paying dividends such as the intended recipient of a dividend not owning any shares at all, or the amount of dividend to be paid to individual shareholders is proportionately out of line with their actual shareholding. Various means have been considered in an attempt to fit a square peg neatly into a round hole such as alphabet shares and dividend waivers by larger shareholders.

Waivers in particular have been the subject of tax cases involving companies owned by spouses and, in the two discussed below, the husbands owned a significantly greater proportion of the issued share capital than their wives. However, presumably for tax efficiency, they wished to receive levels of dividend disproportionate to their shareholdings. The solution seemed to be relatively simple - declare dividends and have the husband waive some or all of his entitlement. Sadly, as we shall see, the taxpayers lost.

In order for a dividend waiver to be possible at all, the company needs to have sufficient reserves to have paid the dividend declared in full. For example, if there were two equal shareholders in a company with £10,000 of reserves, it is not possible to declare a dividend of £20,000 with the intention that one shareholder will waive his full entitlement, leaving the other shareholder to receive his £10,000 in full. The company would have to have distributable reserves of £20,000.

In our first case, **Buck v Revenue & Customs Commissioners (SpC716)**, Mr Buck owned 9,999 shares of Leicester Barfitting Company Ltd and his wife owned 1 share. In the year to 31 March 1999, the company made profits of £35,707 and there was profit carried forward of £46,287. In the following year to 31 March 2000, the after tax profit was £5,647 and the profit carried forward was £46,994.

For the year to 31 March 1999, the company resolved that a dividend of £35,000 per share should be paid, and Mr Buck then waived his right to the dividend. For the year to 31 March 2000, the company again resolved that a dividend of £35,000 should be paid, and Mr Buck again waived his dividend.

The company did not have the distributable reserves to enable dividends to be paid in respect of each of the issued shares. The company would have needed over £300m of reserves.

The Special Commissioner held that there was a "*definite plan, including a relatively simple one, to use a company's shares to divert income falls (sic) within the meaning of an arrangement*". He also stated that there "*was no commercial purpose for either of the waivers and it would surely not have taken place on an arm's length basis*". Therefore, under the Settlements Legislation at Section 660A Income and Corporation Taxes Act 1988, which HM Revenue & Customs (HMRC) tried to invoke in the **Arctic Systems case (Jones v Garnett)**, Mr Buck had retained an interest in the property from which the dividend arose. Effectively, Mr Buck had given his wife a right to income. Accordingly, Mr Buck was taxable on the dividends received by his wife as the settlements were not outright gifts".

In the second case of **Mr P Donovan and Mr P McLaren v The Commissioners for Her Majesty's Revenue & Customs [2014] UKFTT 048 (TC)**, Messrs. Donovan and McLaren held 40 shares each in Victory Fire Ltd, and their wives held 10 shares each.

For the years ending from 31 March 2000 to 31 March 2010, there had been dividend waivers with the broad effect that, while each family received the same total dividend, the split between each husband and wife was different, with the wives receiving disproportionately larger amounts. For example, in the year to 31 March 2010, out of a total dividend of £130,000, Mr Donovan and Mrs Donovan received £52,000 and £13,000 respectively, and Mr McLaren and Mrs McLaren received £33,000 and £32,000 respectively.

HMRC enquired into the self assessment tax returns of the husbands for the year to 5 April 2010 and raised discovery assessments for the preceding two years. Again, HMRC's attack used the Settlements Legislation contained within Section 620 Income Tax (Trading and Other Income) Act 2005 on the basis that the husbands' dividend waivers constituted an "arrangement" and that they were settlors.

Part of HMRC's contention was that, had dividend waivers not occurred in the years from 5 April 2001 onwards, there would have been insufficient distributable profits to pay dividends per share at the rate declared in later years. The tribunal found "t*he irresistible inference from the facts of these appeals to be that the appellants waived their entitlement to dividends as part of a plan to ensure that the dividend income became payable to their wives*". It went on to say that they were "*satisfied on the balance of probabilities that the intention behind the plan was tax geared to bring about a near equalization of the appellants and their wives dividend income thereby reducing their aggregate liability to income tax*". They also "*concluded that irrespective of whether or not there was an intention to avoid tax, an arrangement, and therefore a settlement, clearly existed in this case …*"

So what conclusions can be drawn from these cases?

Firstly, where one spouse waives a dividend and the other spouse does not, then the Settlements Legislation will apply and the spouse who has waived their right, often the husband, will be assessed on at least part of the dividend received by the other.

Secondly, in light of Donovan and McLaren, where there are waivers, a record should be kept of the dividends which would have been paid had there been no waivers, which should be compared with reserves each time a dividend is declared to ensure that there are sufficient reserves to cover the whole dividend without any waivers. In other words, effectively it has to be assumed that prior waivers have not taken place and there needs to be sufficient reserves to cover all declarations of dividend, regardless of whether or not they have been waived.

Finally, with the Arctic Systems case having been won by the tax payer a number of years ago, the obvious way forward in the case of husband and wife companies is to have shares held in the proportions in which they desire to receive dividends. There may be reasons for not doing this: a worry on the part of the spouse with the larger shareholding about the state of their marriage or factors such as the retention of at least a 5% shareholding for entrepreneurs' relief purposes.

As with many tax planning arrangements, the devil is in the detail and having the correct documentation is of crucial importance.

MORTGAGE APPLICATIONS – SUPPORTING INFORMATION REQUESTED BY LENDERS – ANOTHER TWIST

In Issue 133 (August 2015) we outlined details of the Mortgage Verification Scheme and in Issue 134 (October 2015) we advised of changes made by HM Revenue & Customs (HMRC) to the form SA302 (otherwise known as the Tax Calculation) and the Tax Year Overview, which would make it easier to use these as evidence of earnings to mortgage lenders.

It's "all change" again as a result of revisions to the Government Security Classifications which now say that '*fax is no longer considered a secure means of communication for certain documents*'. This means that HMRC will no longer fax agents copies of the SA302 tax calculation or the Tax Year Overview, which many lenders have required as proof of income. Copies can be requested by post from HMRC, but this is likely to cause significant delays.

Where did this start?

This all began with the Financial Conduct Authority demanding greater evidence of income to support mortgage applications. The snag is that the default 'proof' became the SA302 tax calculation as printed from HMRC's system – not a substitute from third party software.

The self-serve option

This is very much an on-going issue, but a growing group of lenders, as listed in Table 1, have agreed to accept SA302s printed from agent's software as long as they are accompanied by a Tax Year Overview from HMRC that confirms the figures. The documents normally required by lenders, are:

- The 'Tax Calculation' for the tax year, showing a breakdown of the income,
- The 'Tax Year Overview' confirming the tax due on the return submitted, any payments made and cross referencing to the Tax Calculation, as printed from agent view from HMRC's system

What to do next

Policy changes are taking time to filter through, so options are:

- If the lender is on the list, they should ask for this 'self-serve' information. If they don't, you should push the issue back to them and ask the branch or broker to refer to the lender's Head Office for confirmation of the most current procedures.
- If form SA302, as printed from HMRC's system is required, this can be obtained by following the procedure at: **https://www.gov.uk/sa302-tax-calculation**. Note that this will not work where the return has been filed on paper or by commercial software. This leaves the even more time consuming and unsatisfactory option of having to phone HMRC and request a copy by post.

List of lenders

The lenders listed in Table 1 should accept self-serve information from agents. HMRC is in discussion with the Council of Mortgage Lenders to encourage take up of this self-serve option.

Table 1

List of lenders

Aldermore
Bank of Ireland
Bank of Scotland
Barclays
Birmingham Midshires
Britannia
Cheltenham & Gloucester
Cheshire Mortgage Corporation
Co-operative Bank
Coventry Building Society
Danske Bank
Ecology Building Society
GE Money Home Lending
Godiva Mortgages Ltd
Holmesdale Building Society
Halifax
Kensington Mortgages
Lloyds Bank
Mortgages PLC
National Westminster Bank
Nationwide Building Society
Nottingham Building Society
Platform
Post Office Ltd
Precise Mortgages
Royal Bank Of Scotland
Saffron Building Society
Santander
Scottish Building Society
Scottish Widows
TSB
Wave Lending
Woolwich

HMRC WITHDRAWS SOME SHARES & ASSETS VALUATION CHECK SERVICES

HM Revenue & Customs (HMRC) has stated that its Shares and Asset Valuation ("SAV") team's resources are being severely stretched and the decision has been taken to withdraw the valuation check service that it previously offered on an informal basis.

Two areas will be affected, namely PAYE Health Checks and Income Tax (Earnings and Pensions) Act 2003 (ITEPA) Post Transaction Valuation Checks. Both these often involve complex valuation scenarios which absorb considerable manpower but result in no change to the valuation proposed. Currently, almost 90% of ITEPA Post Transaction Valuation Checks and PAYE Health Checks are accepted as submitted. These informal services will be withdrawn with effect from 31 March 2016, and any requests for such valuations received after this date will not be processed.

In line with HMRC's "Promote, Prevent, Respond" Compliance Strategy, the SAV team will be updating guidance in its Manual; considering the possibility of running a small number of Valuation Workshops for agents in 2016/17; and working with Special Employer Compliance, Large Business and the Risk & Intelligence Service within HMRC to identify the minority of cases from submitted returns where valuation tax risk exists and where a review of the valuation is appropriate.

SAV will also be examining the valuation check service processes relating to Enterprise Management Incentives (EMI), Company Share Option Plans (CSOP), Save As You Earn share option schemes (SAYE), Share Incentive Plans (SIP) and Employee Shareholder (ES) valuations to consider how these services might be improved. In the meantime these valuation check services will continue as they stand.

Capital Gains Tax Post Transaction Valuation Checks, which SAV operates in conjunction with the Valuation Office Agency, will continue by way of the existing CG34 process.

ALCOHOL WHOLESALE REGISTRATION SCHEME – IMPACT ON BUSINESS

On 1 January 2016, HM Revenue & Customs (HMRC) introduced an Alcohol Wholesale Registration Scheme to tackle alcohol fraud. The registration scheme requires traders to be registered if they sell alcohol wholesale to other traders.

Traders can now apply for registration. The scheme applies to businesses established in the UK who carry out a "controlled activity". This means:

- selling 'controlled liquor' wholesale
- offering or exposing controlled liquor for wholesale sale
- arranging in the course of a trade or business for controlled liquor to be sold wholesale

"Controlled liquor" is alcohol on which duty has been charged and the duty point is at or before the time of sale. This means that sales where the recipient will continue to hold in duty suspension, for example in a bonded warehouse under a duty deferment bond, will not be affected as the alcohol has not passed the duty point. Likewise sales of duty free and denatured alcohol are also not affected.

Exclusions from the scheme

There are exclusions from the scheme for:

- incidental trade sales
- wholesale sales of alcohol between members of the same corporate group

Traders who are mainly retailers but who unknowingly or unintentionally make occasional trade sales will be covered by the incidental trade sales exemption. HMRC's guidance includes a useful flow chart for traders to use to decide whether the exemption will apply, which can be found at: **https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470557/AWRS_flowchart_-_Incidental_Sales_Exemption_v1_2__3_.pdf**.

Wholesale sales of alcohol between members of the same corporate group are excluded from the scheme. However if any members of the group make wholesale sales outside the group they will need to register. If more than one company makes such sales there is an option for those companies to apply for group registration.

Registration

Registration must be done online using a Government gateway ID and HMRC has indicated it will update its guidance to explain how to access the service.

Traders have been advised to prepare for registration by making sure business records are in order, reviewing processes and supply chains to ensure they are sourcing legitimate alcohol, and introducing policies and procedures to prevent involvement in the illicit market.

HMRC will check applications to make sure they have been completed correctly and will return them if any details are missing or unclear. HMRC will also look at whether the business is 'fit and proper' to trade wholesale. Once an application has been approved the trader will receive a Unique Reference Number from HMRC.

If a business fails the "fit and proper" test, then HMRC can remove its right to trade in wholesale alcohol. New criminal and civil penalties will be introduced for wholesalers who sell alcohol without being registered, and for traders who buy alcohol from non-registered wholesalers. Penalties for failure to register for the scheme will apply from 1 April 2016.

Impact of the changes

These changes will have a significant impact in businesses involved in wholesale alcohol sales and their advisers. You can find out more from the HMRC guidance: **https://www.gov.uk/guidance/the-alcohol-wholesaler-registration-scheme-awrs**.

HMRC has also provided two useful flowcharts **https://www.gov.uk/government/publications/alcohol-wholesaler-registration-scheme-awrs-find-out-if-you-need-to-register** to help traders decide whether they need to register and to help retailers decide whether they are covered by the incidental trade sales exemption.

HMRC'S NEW SCHEME TO HELP RESEARCH & DEVELOPMENT CLAIMS

HM Revenue & Customs (HMRC) have launched a new scheme to help small companies claiming Research & Development (R&D) tax relief for the first time. Under the new Advance Assurance Scheme, which can be found at: **https://www.gov.uk/guidance/research-and-development-tax-relief-advance-assurance**, HMRC will allow an R&D claim without further enquiry for a company's first three accounting periods, allowing them to concentrate on their business rather than focussing on their claim.

Advanced Assurance also gives the company proof that it will get R&D tax relief, which may help secure additional funding. Agents can apply for Advance Assurance on behalf of clients. However, HMRC will still need to contact a company director or an employee (for example, research manager).

A company can apply for Advance Assurance whether it is planning to carry out R&D, or has already carried it out. However it must not have claimed R&D tax relief before, its annual turnover must be £2 million or less, and it must employ fewer than 50 people. However, if the company is part of a group and another company within that group has made a claim for R&D, HMRC won't accept an application for Advance Assurance. Also, if the company has entered into a Disclosable Tax Avoidance Scheme (DOTAS) or is a "serious defaulter", then HMRC won't accept an application for Advance Assurance.

If a company is new and doesn't have an annual turnover figure, it can still apply as long as it hasn't claimed R&D tax relief before.

TAX QUERY

Query: *A client has sent me this email: "I have several buy to let properties and am intending to acquire more. With the impending restriction of tax relief for interest on borrowings; the removal of wear and tear allowance; and the proposed increase in stamp duty land tax, which has now been copied in Scotland; I am wondering whether to transfer my existing properties to a limited company and have it purchase any new properties. What are the pros and cons of each alternative? The existing properties are jointly owned with my wife and we are both higher rate tax payers." What should I say?*

Answer: There are a number of matters to consider here, even without the recent Government proposals regarding the taxation of buy to let properties owned by individuals. Certainly, these new proposals are pointing towards the incorporation of such property rental businesses.

You could reply to your client outlining the main points to consider as follows:

"1. Your wife and you both suffer income tax at 40%. A limited company will suffer corporation tax on its profits at 20%, although you will be aware that the Government is intending to reduce the rate of corporation tax to 19% and then 18%. As you are intending to acquire further properties, it will be more cost effective to acquire these out of profits which have only suffered corporation tax at 20% rather than those which have suffered income tax at 40%.

2. Generally, it will be more expensive for your accountant to prepare a set of statutory accounts for a company together with a corporation tax return than it is to prepare a partnership return or property pages for you and your wife.

3. As you note, it is proposed that, over a number of years, income tax relief on borrowings used to purchase buy to let properties will be restricted to basic rate only. If your borrowings are significant, and indeed if they will increase as a result of the acquisition of further properties, then the restriction of income tax relief on interest to basic rate will result in

more tax being payable by you both as individuals.

4. If you have a property business, rather than a passive investment activity, capital gains tax relief under section 162 TCGA 1992 may be available if you incorporate your business and the consideration is settled by way of shares issued by the new company. You may be able to obtain a non statutory clearance, in advance, from HM Revenue & Customs (HMRC) if there is doubt.

5. As you note, in England and Wales the rate of Stamp Duty Land Tax (SDLT) is to increase by 3% in respect of second homes or buy to let properties costing more than £40,000. In Scotland, Land and Buildings Transaction Tax (LBTT) is also to increase. The Land and Buildings Transaction Tax (Amendment) (Scotland) Bill was introduced by Ministers to the Scottish Parliament on 28 January 2016. It is intended to ensure that opportunities for first-time buyers to enter the housing market in Scotland remain as strong as they possibly can, and to avoid a potential distortion of the Scottish housing market when similar UK legislation comes into effect in April, by increasing LBTT by 3% on second homes homes or buy to let properties costing more than £40,000. This mirrors the legislation in England and Wales. The draft Bill and legislative timetable is available on the Scottish Parliament website at: **http://www.scottish.parliament.uk/parliamentarybusiness/Bills/96000.aspx**.

6. If you and your wife are partners in a property business and you incorporate and transfer the existing properties to the new company, then relief may be available from SDLT/LBTT under the partnership rules.

7. From your question, it appears that you intend to continue in the property letting business and indeed increase its size. There is an important difference on the sale of a property by individuals, as compared to a company. An individual is subject to capital gains tax at 28% on the difference between the net disposal proceeds and the original cost of the property (or March 1982 value) and you and your wife will be able to deduct your capital gains annual exemptions to the extent that these have not already been utilised in the year of a disposal. A company does not benefit from an annual exemption but indexation allowance is still available to companies. Inflation is currently very low but, over time, indexation can augment the original cost of a property by a substantial amount when calculating the gain on sale. The rate of corporation tax is only 20% (and this will reduce, as noted above) rather than 28% CGT.

8. The extraction of profits from your company can be an issue. However, if you and your wife have enough income from other sources and are reinvesting the rental profit either by paying off loans or acquiring new properties, then extracting money from the company is not an issue. Otherwise you will be faced with the choice of either paying remuneration or dividends, or putting the company into members' voluntary liquidation if the company is no longer required.

9. Inheritance tax business property relief is not available on rental properties nor on shares in an investment company, such as a property company. It may however be easier for you and your wife to gift small parcels of shares to your children rather than bringing them in as partners in a property business or conveying small interests in each property to them as part of an inheritance tax planning exercise.

You can only plan ahead based on the law as it is just now, but beware of the Trojan horse of a limited company. It is not beyond the realms of possibility that, having effectively pointed residential landlords towards operating their businesses through limited companies, the government may change law in respect of companies too. That said, as the law stands today, it does appear that there are significant advantages in operating through a limited company with few disadvantages."

CLAIMS FOR PRE-REGISTRATION VAT

Any tax adviser worth their salt will make sure that they advise a client registering for VAT to make a claim to recover pre-registration input tax, that is, certain VAT suffered by the business prior to registration.

By way of a reminder of the basic rules, a business can claim pre-registration input tax on its first VAT return under The Value Added Tax Regulations 1995 [SI 1995/2518] Reg 111 in two circumstances:

- In the case of goods, if they are owned by the business on its first date of registration and have been used in the business since they were acquired for the purposes of taxable supplies. The goods must have been purchased within four years of registration.
- In the case of services, only VAT on services purchased within the six months prior to registration can be claimed for and the services must not have been consumed prior to registration.

In 2015, VAT advisers became aware of a change in HM Revenue & Customs (HMRC) internal guidance on this subject. Oddly, this change had been made in 2011 but no one had noticed and indeed, HMRC had not publicised it nor sought to implement it. The revised guidance states:

"You must also take into account any use that has been made of the goods or services prior to registration. For example:

- *A business that is trading below the registration threshold acquires a van;*
- *After three years the business registers for VAT. The van is still on hand at the effective date of registration. The van has been used to make supplies that were not subject to VAT.*

The amount of VAT that can be recovered under regulation 111 should reflect the use of the van for making supplies before registration."

So how does this work in practice? In the above example, assuming the van has a five-year life, and the VAT was £2,000, only two-fifths or £800 would be recoverable. Three-fifths of the input tax, equating to the three years pre-registration, would be disallowed because the supplies in that period were not vatable.

The guidance note adds a comment to cover the question of the treatment of pre-registration VAT suffered on services:

"Six months represents a period in which it is deemed that services obtained will relate to business activity carried on at the time of registration."

Thus HMRC are not applying this restriction to services, only to goods.

This does seem like a reasonable rule. Why should it be possible to reclaim VAT that relates to supplies that are outside the scope of VAT? However, the issue here is that neither UK law (Reg 111 makes no reference to the need to restrict claims in this way), nor case law, supports this change in treatment. Why did HMRC decide to change its policy back in 2011 and not publicise it?

The relevant document with the 2011 change is in HMRC's VAT Input Tax manual at VIT32000 (**http://www.hmrc.gov.uk/manuals/vitmanual/VIT32000.htm**). When questioned, HMRC referred to EU law (Article 289 of the VAT Directive) which states that VAT on goods is only deductible in so far as the goods are used for the purposes of taxable transactions.

What is particularly curious though, is why HMRC has still (at the time of writing) not amended its Public Notices to reflect this change. It is still not being rigorously publicised. In fact Public Notice 700 paragraph 11.1 still reads:

"VAT paid on goods and services that you received before you were registered for VAT is not input tax.

However, when you become registered you can treat this VAT as though it were input tax if you hold acceptable evidence (see paragraph 19.7 which can be found at: ***https://www.gov.uk/government/publications/vat-notice-700-the-vat-guide/vat-notice-700-the-vat-guide#evidence-of-input-tax****) and can meet the conditions set out below.*

You may only recover VAT you incurred before registration which is attributable to making taxable supplies."

Paragraphs 11.2 and 11.3 go on to explain the criteria required in order to reclaim the VAT thus supporting full recovery.

Conclusion

Both UK law and UK case law support full recovery of pre-registration VAT without reference to any restriction for use of the goods prior to registration. Despite this change being published by HMRC in 2011, the public notice (used by most tax payers) still does not reflect it. This matter is still therefore to be concluded on, and will likely be challenged in the courts at some point.

PENSIONS SCHEME ACCOUNTS UPDATE

Just as accountants and auditors are getting to grips with the implementation of Financial Reporting Standard 102 ("FRS 102") and the new Statement of Recommended Practice for Pensions Schemes (2015) ("the Pensions SORP"), there are some further changes to take on board: The Pensions Research Accountants Group ("PRAG"), which is the SORP-making body, has issued comments on amendments to FRS 102; the Financial Reporting Council (FRC) has proposed changes to the fair value hierarchy disclosures in FRS 102; and the Department of Work and Pensions ("DWP") is expected to bring in changes to the audited accounts regulations for pension schemes to streamline investment disclosures. The timing of the changes to FRS 102 covered by the PRAG guidance is certain but there remains a degree of uncertainty over the timing of the proposed changes to the fair value hierarchy and the audited accounts regulations. A further planned change to the audited accounts regulations is likely to lead to the requirement for the auditor's statement on the statement of contributions being dropped for schemes with more than 20 participating employers.

Guidance issued by PRAG on amendments to FRS 102

Since the Pensions SORP was published in November 2014, there have been a number of amendments to FRS 102. Two of these amendments are of particular relevance to accounts preparers and auditors for periods commencing on or after 1 January 2015:

- **Disclosure requirements when accounts depart from FRS 102** FRS 102 has been amended to align it to UK legal references to 'true and fair' reporting rather than to 'fairly present' when the accounts of an entity depart from FRS 102.

- **Definition of a related party**
  The definition of a related party has been extended to include 'An entity ......or any member of a group of which it is a part, [which] provides key management personnel services to the reporting entity or to the parent of the reporting entity.'

  In the context of pension schemes, key management personnel are normally the trustees. In some instances key management personnel services may be provided by a corporate entity, for example, a trustee company, which will then also be a related party.

PRAG is not republishing the Pensions SORP to take account of these amendments and has instead published additional guidance which can be found at: **http://www.prag.org.uk/25/** and should be read in conjunction with the SORP.

Proposed changes to the fair value hierarchy disclosures under FRS 102

The FRC is proposing changes to the fair value hierarchy disclosures within FRS 102 for pension schemes (referred to in the standard as retirement benefit plan) and financial institutions to align these with International Financial Reporting Standards (IFRS). Full details of these changes can be found at: **https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRED-62-Draft-amendments-to-FRS-102-Financial-Rep.aspx**.

The proposed amendments will only go some way towards aligning the fair value hierarchy in FRS 102 with IFRS. However, this development is certainly a step in the right direction and should make it easier for pension schemes to obtain the information they need from investment managers and custodians to prepare FRS 102 compliant accounts.

The intention is for the amendments to FRS 102 to take effect for periods commencing on or after 1 January 2017. It is also positive that early adoption is to be permitted for periods commencing on or after 1 January 2015 for accounts which have not been approved by the time the FRC issues the final changes.

Audited accounts regulations

The DWP has consulted on changes to the Occupational Pensions Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 "(the audited accounts regulations") which are expected to take effect for pension scheme accounts approved on or after 1 April 2016. However, amendment regulations have not yet been laid before the UK Parliament.

The audited accounts regulations require certain disclosures to be made about scheme investments and other assets but, with the implementation of FRS 102, these have fallen out of date. The proposed changes remove most of the detailed investment disclosures and require a statement in the audited accounts that the accounts have been prepared in accordance with FRS 102 and the Pensions SORP, noting any material departures.

Another important proposed change to the audited accounts regulations is an exemption for multi-employer schemes with at least 20 participating employers which are not connected, from the requirement to obtain a statement from the scheme auditor on whether, in their opinion, contributions have been paid in accordance with the scheme's schedule of contributions.

FINANCIAL REPORTING STANDARD 102 – TRANSITION REQUIREMENTS – OUT WITH THE OLD AND IN WITH THE NEW

Financial Reporting Standard (FRS) 102 became applicable for accounting periods commencing on or after 1 January 2015. Therefore, for many entities, 31 December 2015 year ends will be the first accounts prepared under the new standard. While for some entities this may not mean any significant change, for others there will be considerable amendments required to the client's accounting. It is also worth noting that the coming into force of FRS 102 also means that all previous FRSs, Statements of Standard Accounting Practice (SSAPs), and Urgent Issues Task Force (UITF) Abstracts have been withdrawn.

Date of transition

The client will need to prepare an opening balance sheet at the date of transition under FRS 102. The date of transition is the opening date of the client's previous financial period. For 31 December 2015 year ends the date of transition will be 1 January 2014. This balance sheet does not require to be published. The comparative period balance sheet also requires to be re-stated under FRS 102 ie the balance sheet at 31 December 2014 previously prepared under old UK GAAP.

Transition procedures

General Principle

Section 35 of FRS 102 deals with transition and applies to a first-time adopter of the standard. The general principle is "full retrospective application" ie the financial statements are prepared as if the requirements of FRS 102 had always been in force. However, there are a number of mandatory and optional exemptions to this rule.

When compiling its balance sheet as at the date of transition an entity is generally required to:

(a) recognise all assets and liabilities whose recognition is required by FRS 102;

(b) not recognise items as assets or liabilities if FRS 102 does not permit such recognition;

(c) reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of equity, but which are now a different type of asset, liability or component of equity under FRS 102; and

(d) apply FRS 102 in measuring all recognised assets and liabilities.

Mandatory exceptions to retrospective restatement

However, an entity is not allowed to retrospectively change the accounting that it followed under its previous financial reporting framework for any of the following transactions:

(a) Derecognition of financial assets and financial liabilities: financial assets and liabilities derecognised under an entity's previous accounting framework before the date of transition shall not be recognised upon adoption of FRS 102.

Conversely, for financial assets and liabilities that would have been derecognised under FRS 102 in a transaction that took place before the date of transition, but that were not derecognised under an entity's previous accounting framework, an entity may choose:

(i) to derecognise them on adoption of FRS 102; or

(ii) to continue to recognise them until disposed of or settled.

(b) Accounting estimates

(c) Discontinued operations

(d) Measuring non-controlling interests:

The requirements:

(i) to allocate profit or loss and total comprehensive income between non-controlling interest and owners of the parent;

(ii) for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

(iii) for accounting for a loss of control over a subsidiary

shall be applied prospectively from the date of transition to this FRS (or from such earlier date as this FRS is applied to restate business combinations).

Optional exemptions

Section 35 contains a total of 20 optional exemptions from retrospective application – those that are likely to be most widely relevant are discussed below:

- **Business combinations, including group reconstructions:** an entity may elect not to apply FRS 102 to business combinations that were effected before the date of transition to FRS 102. However, if a first-time adopter restates any business combination to comply with FRS 102, it shall restate all later business combinations.
- **Share-based payment transactions:** an entity may elect not to apply FRS 102 to equity instruments (including the equity component of share-based payment transactions previously treated as compound instruments) that were granted before the date of transition, or to liabilities arising from share-based payment transactions that were settled before the date of transition. Entities choosing this option that previously applied FRS 20 or International Financial Reporting Standard (IFRS) 2 Share-based Payment should continue to apply that standard. Entities are not required to apply FRS 102 to liabilities arising from share-based payment transactions that were settled before the transition date. In addition, for a small entity that first adopts FRS 102 for an accounting period that commences before 1 January 2017, this exemption is extended to equity instruments that were granted before the start of the first reporting period that complies with FRS 102, provided that the small entity did not previously apply FRS 20 or IFRS 2.
- **Fair value as deemed cost:** an entity may elect to measure an item of property, plant and equipment; investment property; or intangible asset which meets the recognition criteria and the criteria for revaluation on the date of transition at its fair value, and use that fair value as its deemed cost at that date.
- **Revaluation as deemed cost:** an entity may elect to use a previous GAAP revaluation of an item of property, plant and equipment; investment property; or intangible asset which meets the recognition criteria and the criteria for revaluation at, or before, the date of transition to this FRS as its deemed cost at the revaluation date.
- **Individual and separate financial statements:** for investments in subsidiaries, associates and jointly controlled entities, an entity can use the carrying amount at the transition date under old UK GAAP as the deemed cost going forward.
- **Arrangements containing a lease:** an entity may elect to determine whether an arrangement existing at the date of transition contains a lease on the basis of facts and circumstances existing at that date, rather than when the arrangement was entered into.
- **Dormant companies:** a company within the Companies Act definition of a dormant company may elect to retain its accounting policies for reported assets, liabilities and equity at the date of transition until there

is any change to those balances or the company undertakes any new transactions.

- **Deferred development costs as a deemed cost**: an entity may elect to measure the carrying amount at the date of transition for development costs deferred in accordance with SSAP 13 as its deemed cost at that date.
- **Borrowing costs:** an entity electing to adopt an accounting policy of capitalising borrowing costs as part of the cost of a qualifying asset may elect to treat the date of transition as the date on which capitalisation commences.
- **Lease incentives:** an entity may choose not to apply FRS 102 lease incentives provided the term of the lease commenced before the date of transition – instead they may continue to apply the previous accounting treatment.
- **Hedge accounting:** an entity may apply hedge accounting prior to the documentation requirements being met, provided that the required documentation is in place no later than the date the first FRS 102 financial statements are authorised for issue.
- **Small entities - fair value measurement of financial instruments:** a small entity that did not measure financial instruments at fair value under its previous GAAP is not required to restate its comparative period information to comply with the fair value measurement requirements of FRS 102. This is only applicable to first time adoption prior to 1 January 2017.
- **Small entities – financing transactions involving related parties:** a small entity is not required to restate comparative information in accordance with the accounting requirements for financing transactions involving related parties under Section 11 – Basic Financial Instruments. This is only applicable to first time adoption prior to 1 January 2017.

Disclosures

Section 35 requires the notes to the accounts to explain how the transition from previous GAAP has affected an entity's reported financial position and performance. For small entities applying section 1A of FRS 102, this disclosure is encouraged but not required (although there is an overriding requirement to provide a true and fair view).

This explanation should include the following:

- a description of the nature of each change in accounting policy.
- reconciliations of equity determined in accordance with previous GAAP to the equity determined under FRS 102 for: the date of transition (eg 1 January 2014), and the end of the last period presented in the most recent financial statements under previous GAAP (eg 31 December 2014).
- a reconciliation of profit or loss under previous GAAP for the latest period in the entity's recent financial statements to the profit or loss under FRS 102 for the same period.

The standard does not provide formats for the reconciliations, but the Financial Reporting Council (FRC) Staff Education Note (SEN) 13 suggests two alternative formats that entities may choose to adopt, either:

(i) a line-by-line reconciliation of the profit and loss account and balance sheet; or

(ii) Profit/equity under existing GAAP +/- reconciling items = Profit/equity under FRS 102

An entity should choose a presentation most suitable to its particular circumstances.

The most up-to-date versions for FRS 102 and SEN 13 are available from the following links:

https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-applicab.pdf

https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/SEN-13-Transition-to-FRS-102-(amended-Oct-2015).pdf

ACCOUNTING AND AUDITING QUERIES

Query: *I am a partner in a medium size firm of chartered accountants. I have recently been reviewing the specific requirements within Financial Reporting Standard (FRS) 102 in respect of revaluing fixed assets (excluding investment properties). Section 17 of FRS 102 states that valuations should remain up to date but does not appear to specify a time period for which valuations must be performed. FRS 15 on the other hand requires a full valuation of properties which have been revalued to be performed every 5 years with an interim valuation performed in year 3. Additionally, it states that an interim valuation should also be carried out in years 1, 2 and 4 where it is likely that there has been a material change in value.*

Could you please advise whether you believe this change in requirements will result in the need for more frequent or less frequent valuations?

Answer: As you have found, FRS 102 is not as specific as FRS 15 with regards to how often revaluations need to be undertaken. It merely sets out the general principle that revaluations should be made with sufficient regularity that

the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period [FRS 102 para 17.15 B]. This therefore imposes no specific time interval for valuations, but rather the interval is determined by the movements in fair value.
The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value, again determined by appraisal.

FRS 102 also recognises that:

"If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach."

So, the frequency of revaluation will be dependent on movements in the fair value of property, plant and equipment. Where the fair value of a revalued item of property, plant and equipment at the balance sheet differs materially from its carrying amount, a further revaluation is necessary. It is therefore the susceptibility of the asset concerned to movements in fair value that will be the determining factor as to when a revaluation is needed. It could be argued that the property market may generally be considered more volatile (obviously dependent on market conditions) than might be the case with the market for plant and machinery. Professional judgement will have to be applied.

A material change in value could be considered as a change that would reasonably influence the decisions of a user of the accounts. Management will need to apply judgement, but it would be advisable for them to consult professional valuers and consider, amongst other things, factors such as changes in the general market; the condition of the asset; changes to the asset; and its location, to help inform their assessment.

Management should consider introducing a process by which it can monitor the movements in fair value each year, even if this does not amount to a full annual revaluation. This process could help to inform management's assessment by requiring them to obtain information on general fair value movements as well as having periodic consultations with their valuers.

Query: *I am a partner in a small firm of chartered accountants. I have a medium private company client which undertakes a lot of acquisitions and is likely to continue doing so, at least in the short-term. I am aware that the Financial Reporting Standard (FRS) 102 came into effect for accounting periods commencing on or after 1 January 2015. Given the business model operated by this particular client, I was therefore wondering if there is any difference in treatment for the accounting for expenses associated with such acquisitions eg legal fees etc.*

Also, could you please confirm over what period the goodwill associated with any particular acquisition would need to written off over? Is it 5 years, 10 years, or indeed some other period.

Answer: Under FRS 102, the guidance as to what should be recognised as acquisition costs is similar to old UK GAAP.

Paragraph 19.11 of FRS 102 states:

"The acquirer shall measure the cost of a business combination as the aggregate of: (a) the fair values, at the acquisition date, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus (b) any costs directly attributable to the business combination."

The cost of the business combination will therefore include expenses limited to those incurred directly in making an acquisition. Such direct costs are likely to include incremental costs such as professional fees paid to investment banks, accountants, legal advisors, valuers and other consultants. The general principle is that the costs should be direct and incremental to the business combination and hence would not have been incurred if the combination had not occurred. So, as is often the case, professional judgement will need to be applied. Your client will have to assess which of the costs would meet the definition of acquisition costs and, as a result, form part of the cost of investment. Any remaining costs which do not come within the definition of acquisition costs should be written off and not included in the cost of the investment.

Goodwill is defined as the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities.

As per paragraph 19.23 of FRS 102 (September 2015 version):

"….Goodwill shall be considered to have a finite useful life, and shall be amortised on a systematic basis over its life. If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed 10 years."

Please note that the general principle is that goodwill should be amortised on a systematic basis over its life. This period may be less than or indeed even greater than 10 years. It is only in exceptional circumstances where an entity is unable to make a reliable estimate of useful life that goodwill is prohibited from being amortised over a period exceeding 10 years (this represents a change from earlier versions of FRS 102 where this period was restricted to 5 years).

TECHNICAL BULLETIN

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