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You'll Be Given a Fair Trial And Then Shot! HMRC 'Accelerated Payment' and 'Follower Notices'

Certain clauses in the current Finance Bill made it through to the Royal Assent in July, giving HMRC the power to demand tax and to close cases with no effective right of appeal for the taxpayer.

The recent cleverly managed PR campaign against tax avoidance has produced a climate of opinion which has made it possible for HMRC to be given the power to decide the outcome of certain tax disputes without the taxpayer concerned being allowed to have their view tested in the courts.

The new 'dictatorship' comes in two forms –'Accelerated Payment Notices' and 'Follower Notices'.

Accelerated payment notice

At present, if there is a dispute between HMRC and the taxpayer about how much tax is due, broadly speaking HMRC must wait for their tax until they can get a court to say they are correct and the tax should be paid. It has to be admitted that some of the more disreputable tax avoidance schemes actually used this as a selling point – if there are millions at stake, a delay of a year or two in payment is not as good as avoiding the tax completely, but it is certainly worth having.

Once the Finance Act 2014 becomes law, in certain circumstances HMRC can issue an 'Accelerated payment notice' requiring the disputed tax to be paid within 90 days. The taxpayer has no right of appeal, beyond "making representations" to HMRC. If HMRC do not back down, the tax is payable and it is not possible to appeal to the courts against such a notice.

These notices can be issued in three situations:

- Where the tax avoidance scheme is one disclosed under the DOTAS rules (which apply to most tax avoidance schemes on the market); or
- HMRC are using the new GAAR ("General Anti-Abuse Rule") to challenge the scheme; or
- The dispute is sufficiently similar to one decided in HMRC's favour by the courts – see below.

Note that the rules apply to existing disputes

as well as to ones arising after this July, so if you are currently arguing about a DOTAS scheme, you may well get such a notice.

Follower notice

These are even more sinister. Where HMRC believe that there is a 'final' decision by the tax tribunal or the Courts which, if applied to the dispute they are having with you, would mean that they would win the argument, they can require you, effectively, to give up and agree with them, either by amending your tax return or withdrawing your appeal, as the case may be.

The requirement that a court decision be 'final' does not mean it must have been made by the Supreme Court – it could have been made by a lower court or even the tax tribunal if the taxpayer concerned could not afford to take it any further.

Once again, the only appeal is to HMRC themselves, not to the courts, and if you refuse to comply, and continue your litigation and lose, you will face a penalty of between 10% and 50% of the tax that was in dispute – and you will already have had to pay that tax anyway because of the 'accelerated payment' powers.

You cannot appeal (except to HMRC), so we shall be relying on HMRC being fair and objective in how they compare the decided case with yours.

Of course, they assure us that they will be benevolent dictators. However, past experience leaves me with little confidence in their assurances.

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Losing Control (In Stages)! Gifts Of Shares

If you want to pass on your property investment company to your children, you are faced with a problem, because such shares do not qualify for capital gains tax (CGT) holdover relief. You could be charged to CGT as if you had sold the shares for their market value.

One possibility is the use of a discretionary trust – the details are beyond the scope of this article – which will allow you to make gifts up to your 'nil rate band' for inheritance tax (IHT) purposes (currently £325,000) every seven years. If you transfer more than £325,000 of value, you will have to pay IHT at the 'lifetime rate' of 20% on the excess. This is because a gift to a trust is a 'chargeable transfer' for IHT – and that is why you are allowed to hold over the capital gain.

Valuing gifts

Gifts are valued differently for IHT and CGT. For CGT, the gift is the value of the asset given away, but for IHT, the value transferred is measured by how much the giver's estate has reduced. This may sound like a distinction without a difference, but when it comes to shares in an investment company, the difference becomes very real and potentially expensive.

For example, if a company is worth £1 million, how much would you pay for a 10% stake in it - £100,000? Think about it – as a 10% shareholder, you have very little influence over how a company is run, you can be outvoted, and you have no influence over when dividends are paid. The conventional wisdom is that you would only be prepared to pay about 15% to 25% of the proportionate value – between £15,000 and £25,000.

Different discounts apply to different levels of shareholding. A crucial difference is that between 49% of the shares and 51% of the shares, for obvious reasons – if you own 51% of the shares, you can control what the company does in most (but not all) situations. For our £1 million company, a 51% shareholding might be worth £459,000 (a discount of 10%), but a 49% shareholding would only be valued at around £245,000 (a discount of 50%).

This discount could be larger – for example, if all the other shares are held by one individual – and a 49% holding could be worth as little as £147,000 (a discount of 70%).

A valuation trap

Given that the value transferred to a discretionary trust will be measured in the IHT style – not what the recipient received, but what the giver lost – care is needed when valuing the gift to be given, because if you exceed your nil rate band of £325,000, you will be faced with an immediate charge to IHT at the 'lifetime rate' of 20%.

Example – The over-generous gift

Mr Scrooge owns all the shares (1,000) in a property letting company, which is valued at £1,000,000. He wants to pass on the company to his son and sets up a discretionary trust, to which he gives 325 shares, reasoning that if the company is worth £1 million, then each of the 1,000 shares is worth £1,000 and he is exactly within the £325,000 limit.

In fact, the calculation goes like this:

Value of 100% holding before the gift	£1,000,000
Value of 67.5% holding after gift (20% discount)	£540,000
Transfer of value for IHT	£460,000
IHT (£460,000 - £325,000 = £135,000 @ 20%)	£27,000

By forgetting the principle that the IHT value transferred is the value he loses, not what his son gains, Mr Scrooge has let himself in for an unpleasant and costly surprise.

Practical Tip:

When making gifts of shares in an investment company, remember how these discounts work and seek the advice of a specialist in valuing shares, to ensure your gift does not trigger an unexpected liability to IHT.

Tax Relief For Trading Losses – Is It 'Commercial'?

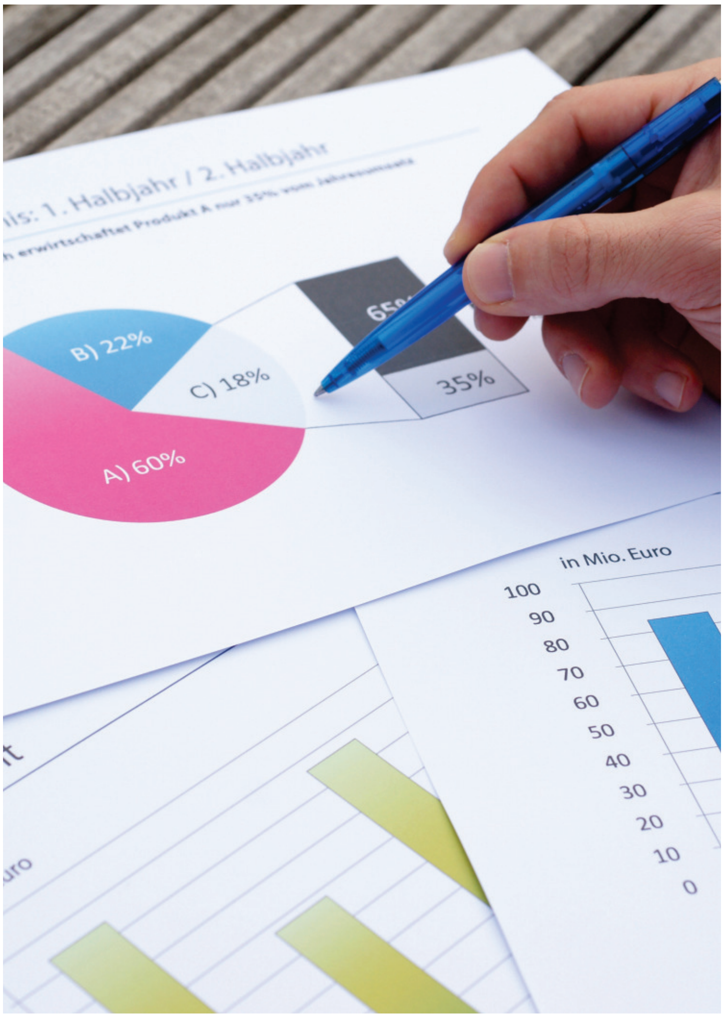
If a sole trader or a partnership makes a loss in their trade, that loss can be carried forward against future profits, or set against other income for the tax year concerned or for the previous year, and also against capital gains of the tax year. This relief against other income or gains is sometimes referred to as 'sideways' loss relief.

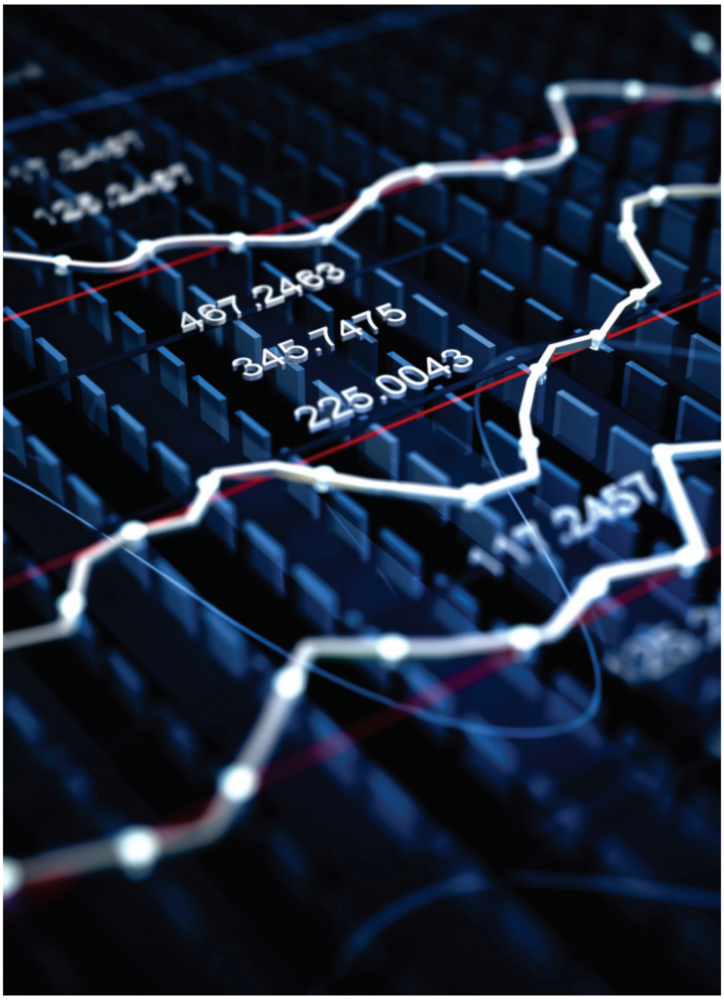
There are various restrictions on sideways loss relief, and one is that the loss-making trade must have been carried on 'on a commercial basis and with a view to the realisation of profits of the trade' (see section 66 ITA 2007).

It is important to realise that these rules only restrict sideways relief. There is no restriction on carrying losses forward against future profits.

A recent case (Murray v Revenue & Customs (2014 UKFTT 338 (TC)), involved losses of a business described as 'Race Horse Bloodstock Breeding and Training'. There is special legislation and agreed HMRC practice relating to stud farms (which are a type of 'farming' for tax purposes) that restricts setting losses against other income after eleven years of continuous losses, but HMRC refused relief for the tax year 2010/11 after the trade had only been carried on for six years, and on the more general grounds of 'commerciality' and 'realisation of profit'.

In the year they picked, there was no income at all, and expenses of over £28,000. The breeding side of the business did not look hopeful as Mr Murray's stock of horses in the year in question consisted of an infertile mare and three geldings. The business plan for the 'training' appeared to involve entering the geldings for races in the hope of enhancing their value for sale. Racing horses (as distinct from being paid to train other people's horses to race) has long been held not to be a trade, so Mr Murray had little hope of success and he lost his case.





HMRC should not, however, simply attack loss claims on the basis that the trade has not made a profit yet – the test is whether it is reasonable to expect to make a profit in the future, and whether the trade is being carried on in a businesslike way. HMRC tend to go overboard on this second point, demanding profit forecasts and cash flow projections and when these are not available asserting that the trade is not being conducted 'on a commercial basis'.

Hansard, the official parliamentary record, can be used to assist in interpreting the meaning of tax legislation, and it is sometimes useful to remind HMRC that when the legislation was introduced into parliament the Chancellor of the Exchequer said:

"We are after the extreme cases in which expenditure very greatly exceeds income or any possible income which can ever be made in which, however long the period, no degree of profitability can ever be reached."

This can be found in paragraph BIM85705 of HMRC's Business Income Manual.

There are not many decided cases on 'uncommercial' trades and HMRC seem generally reluctant to go to the Tribunal to defend their refusal of sideways relief.

The most vulnerable taxpayers are those effectively financing their hobbies by seeking to get paid for some aspect of them. Horses are often involved in one way or another but I have also come across car rallying, dog training, and, once, ballooning! Just because you enjoy your work, however, does not mean it is 'uncommercial'.

Practical Tip:

Provided there is some prospect of future profits, and provided you are trying to run the venture in a businesslike way, do not be intimidated by an HMRC challenge. Make sure you quote the Hansard extract to them, and present a robust case for your business being commercial and potentially profitable.

Personal Tax

Make Use Of Loans To Directors

Used wisely, loans from a family company to a director can be a cheap source of temporary finance. As long as the loan is paid back within nine months and one day of the end of the accounting period in which it was made, there is no tax to pay on the loan, other than the benefit-in-kind charge that arises if the loan is not small. This will be the case where the outstanding loan balance exceeds £10,000 at any point in 2014/15. These rules allow the director to make use of the money tax-free (or virtually tax-free) for up to 21 months.

Under the loans to participators rules, a tax charge of 25% of any loan balance which remains outstanding at the corporation tax due date (nine months and one day after the end of the accounting period) must be paid over to HMRC. This tax is set against the corporation tax liability for the accounting period in which the loan is repaid. It is possible to avoid the tax charge by repaying the loan before the corporation tax due date, but care must be taken not to fall foul of either the 30-day rule (which renders repayment of £5,000 or more ineffective if the funds are re-borrowed within 30 days) or the intentions and arrangements rule (under which repayments of £15,000 or more are deemed ineffective if arrangements exist to re-borrow the funds at the time that the repayment is made).

Case Study:

Matt is the director of his family company, which is close. The company prepares accounts to 31 March each year. During the year to 31 March 2015, Matt needs to borrow £8,000 to do some work on the family home. He borrows the funds from the company on 6 April 2014. The loan is cleared by a dividend which is declared on 30 December 2015.

As the loan balance is less than £10,000 throughout 2014/15 there is no benefit in kind to pay on the loan, or any Class 1A NIC. The loan is repaid by 1 January 2016 (the due date for corporation tax for the year to 31 March 2015), so there is no tax to pay under the loans to participators rules.

Matt is able to enjoy the use of the money tax-free for nearly 21 months – much cheaper than a bank loan.

Property Tax

Pre-Letting Repairs

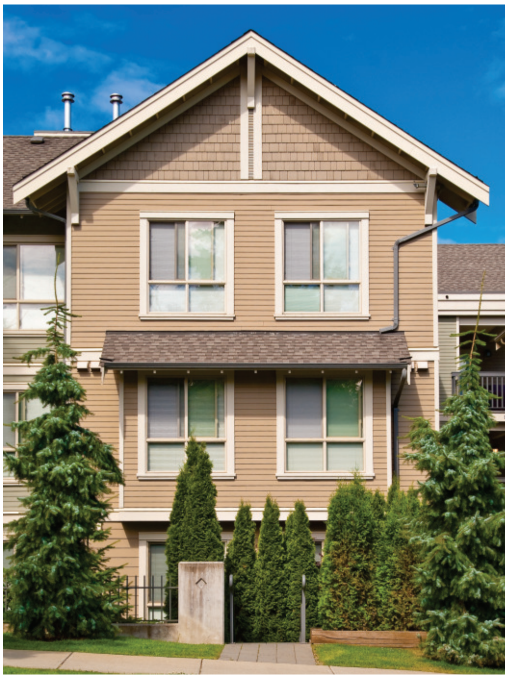
Expenses for repair and maintenance incurred prior to the first letting income received may be allowable provided certain conditions are met, namely that:

- the cost is for the replacement of worn or dilapidated items;
- the property was in a fit state of repair for use in the letting business prior to its actually being let;
- the price paid for the property was not substantially reduced to take into account its dilapidated state of repair; and
- the purchase price, if reduced, was reduced only to take into account 'normal wear and tear'.

Case Study:

The surveyor's report undertaken on the purchase of a property will often include an estimate of the rental income that could be derived from a property; this can be useful evidence that the property was in a 'fit state of repair' before money is spent on repairs.

Alternatively the taking of photographs before repairs are undertaken could be admitted as proof.



Business Tax

Agree The Split Of Partnership Profits And Losses

The legal definition of a partnership is the relationship that subsists between persons carrying on a business in common with a view to profit.

In a simple partnership the partners share profits and losses in accordance with a pre-agreed profit sharing ratio. A partnership is not a separate legal entity and partners are jointly and severally liable for the debts and losses of the partnership.

Normally one would want the partnership agreement to be crystal clear on the split of profits. However, where the partnership comprises a husband and wife or civil partners, it may be advantageous to have a more loosely worded agreement to provide some flexibility in profit allocation; to allow profits to be split in a way that minimises their combined tax liability. This could be achieved by a clause in the agreement which provides for profits to be determined in such a ratio as is agreed by the partners.

Case Study:

William and Ann are husband and wife and are in partnership together. As their other income fluctuates they decide to keep the partnership agreement loose as to the share of profits and agree the split each year depending on their other income.

In year 1 William has other income of £20,000 and Ann has no other income. The profits of the partnership are £50,000 and are allocated £35,000 (70%) to Ann and £15,000 (30%) to William to equalise income and minimise tax liabilities.

In year 2, neither has any other income and profits from the partnership are £70,000. They agree to split the profits equally. The absence of a set profit sharing ratio in the agreement provides the flexibility to allocate profits in a tax-efficient manner.

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