Smith & Williamson

# Tax update

## A round-up of recent issues

14 May 2019

# 1. General

## 1.1 Crown Dependencies update guidance on new tax residency rules

*Jersey, Guernsey and the Isle of Man have jointly released updated guidance on the new economic substance requirements for tax residency. Under the new requirements, some companies must meet set criteria to demonstrate sufficient economic substance in the jurisdiction before they will be resident for tax purposes.*

The guidance expands on the new residency requirements, which have effect from 1 January 2019. These were implemented following the EU's finding that the Crown Dependencies' residency laws allowed businesses to attract profits artificially without sufficient economic activities or economic presence in the jurisdiction. The guidance explains how the scope and operation of the requirements will affect specific sectors and provides more detail on the criteria of economic substance.

The economic substance requirements only apply to certain industries, such as banking, financing, holding companies and companies holding intellectual property. The Crown Dependencies have indicated that further guidance should follow.

*www.gov.im/media/1365807/economic-substance-guidance-joint-guernsey-isle-of-man-and-jersey-26-april-2019.pdf*

## 1.2 HMRC to delete voice ID records for 5 million taxpayers

*The Information Commissioner's Office (ICO) has concluded that HMRC collected records for voice authentication unlawfully, as it did not have the specific consent of taxpayers to hold this biometric data, thus breaching the General Data Protection Regulation (GDPR).*

In January 2017, HMRC began to encourage taxpayers who called its automated helpline to register for voice identification by repeating the phrase 'my voice is my password'. No further consent was required, and initially there was no means of opting out. The ICO has issued an enforcement notice requiring deletion of around 7 million records by 5 June, as collecting biometric data without clear consent is a breach of GDPR.

HMRC has changed the way it obtains permission, and will retain records for the 1.5 million taxpayers who have updated their permission on the helpline. The remaining 5 million records will be deleted, though HMRC has pointed out that the scheme is popular with taxpayers, allowing them to get through to an adviser more quickly.

*https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/799688/Letter_from_Sir_Jonathan_Thompson_to_HMRC_Data_Protection_Officer_-_3_May_2019.pdf*

## 1.3 HMRC report on the drivers of tax compliance among the wealthy

*HMRC has published a report into what drives tax compliance for wealthy taxpayers, and how to improve it.*

The report is intended to increase understanding of attitudes and behaviour, rather than being a survey, as it is based on in-depth interviews. The report covers how wealthy taxpayers see themselves, what shapes their behaviour, how they plan and structure their tax affairs, their views on tax avoidance and evasion, and what HMRC could do to encourage their voluntary compliance.

Points taken from the interviews included the stress caused to taxpayers by uncertainty on HMRC's position, and their concerns over potential reputational damage, as well as their desire to contribute to society.

*www.gov.uk/government/publications/researching-the-drivers-of-tax-compliance-behaviour-among-the-wealthy-and-ways-to-improve-it*

## 2. Private client

### 2.1 Loss relief carry forward disallowed for member claiming as sole trader

*The FTT has refused to allow an accountant to use losses from his first limited liability partnership (LLP) against the profits of the LLP to which he moved. The penalty was cancelled due to his making a full disclosure in a white space note on the return.*

An accountant operated an LLP of which he was the sole individual member, and claimed considerable losses on its cessation, partly from draft accounts prepared much later. He set these losses against his profit share in the LLPs to which he moved by reporting the income as a sole trade. This was on the grounds that he was operating a consultancy business to the same client body under the 'umbrella' of different firms, and was not, in fact, a member in the later LLPs. The FTT agreed with HMRC that the trades of the LLPs were distinct, so the taxpayer could not use the losses against his profits in later years, and found that he was a member of the later LLPs.

The inaccuracy penalty, which HMRC originally levied at 70%, was cancelled as the taxpayer believed that his returns were correct, and had explained his grounds for reporting as a sole trader in a white space note.

*Shanks v HMRC* [2019] UKFTT 279 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07118.html*

### 2.2 FTT examines definition of ordinary shares for Entrepreneurs' Relief (ER)

*The FTT has determined that cumulative fixed-dividend preference shares carrying a right to a 10% dividend were ordinary share capital for ER. The 10% dividend was calculated on the share capital plus a variable so was not a fixed rate.*

The taxpayer held less than 5% of the ordinary shares of the shares in his company but over 5% if his preference shares were taken into account. The preference shares carried a right to a dividend at a rate of 10%, which was cumulative such that, if any dividends remained unpaid due to lack to reserves, he would accumulate a dividend of 10% on them. If the rate of the dividend was fixed, these shares would not be defined as ordinary share capital for ER.

HMRC guidance is that this type of share is not ordinary share capital, but the tribunal held that the cumulative element of the dividend meant that the rate was not fixed, and therefore awarded ER to the taxpayer. This may therefore lead to uncertainty for taxpayers with a 5% ordinary share holding that could be diluted below 5% by such preference shares held by others.

*Warshaw v HMRC* [2019] UKFTT 268 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07107.html*

### 2.3 Court of Appeal lays down principles for follower notices

*The CA quashed a follower notice, and therefore the accelerated payment notice based on it, on a tax scheme known as a Round the World Scheme. In doing so it, made it clear that it would carefully circumscribe HMRC's powers to issue follower notices, whose utility the court understood, but thought draconian.*

HMRC issued a follower notice to the users of a 'Round the World' scheme which purported to avoid tax through the careful planning of trustees' and companies residence. The scheme was similar to that used in the case of *Smallwood v HMRC* [2010] EWCA Civ 778 [2010] STC 2045. HMRC had maintained that this case met the requirements as a final ruling for the purposes of a follower notice.

The CA found HMRC had misdirected itself in two ways. First, the actual judgment of the CA in Smallwood was only that the FTT had been entitled to find in that case that the scheme failed because the trustees in question were in fact UK resident. That did not mean that another finding might not be possible.

Second, HMRC had proceeded on the basis that it only had to be more likely than not that it would succeed in court. The test was that HMRC should have a 'substantial degree of confidence in the outcome'.

*R v HMRC ex parte Haworth* [2019] EWCA Civ 747

*www.bailii.org/ew/cases/EWCA/Civ/2019/747.html*

## 2.4 FTT cancels return issued due to PAYE underpayment

*HMRC issued a return to a taxpayer because he did not respond to requests to settle a PAYE underpayment direct. The tribunal found that the notice to file was issued on invalid grounds, and therefore cancelled it.*

The taxpayer's only significant income was his salary and employment benefits, which were taxed under PAYE. An underpayment arose, which HMRC had difficulty in collecting. The taxpayer contended that he did not receive a PAYE calculation, and that HMRC should be able to collect any underpaid tax from his current PAYE income. HMRC responded by registering the taxpayer for self-assessment, and issuing a notice to file in order to collect the tax.

The tribunal took the view that the notice to file was not for the purpose of establishing the amount of tax due, as this was already known to HMRC, and the notice was therefore invalid as it was simply for enforcement purposes. It cancelled the notice to file, and therefore the associated late filing penalties.

*Hurst v HMRC* [2019] UKFTT 286 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07125.html*

## 2.5 Penalty for deliberate withholding of information upheld

*The FTT has rejected an appeal against a penalty for deliberate withholding of information, although when the information was supplied over three years late it reduced the estimated liability that the taxpayer had paid.*

A taxpayer whose return was over three years late was issued with a penalty for deliberating withholding information, tax-geared to a determination. He had previously paid the determination and numerous smaller late filing penalties, without filing a return, though he believed the determination was excessive. On receipt of this much greater penalty, he filed his return, showing a tax liability over £30,000 less than that in the determination. The tax-geared penalties were reduced in proportion to the reduction in the tax bill.

The taxpayer appealed the £26,000 penalty for deliberately withholding information, as when produced it had reduced his liability, so the withholding could not have been deliberate. The FTT rejected this argument, finding that a deliberate choice did not have to be accompanied by the intention to underpay tax. He had made a conscious, if unwise, decision not to file.

The taxpayer also argued that he had a reasonable excuse for late filing, as he did not realise the extent of the penalties HMRC were entitled to impose. This was also rejected. The FTT found that '*a belief as to the consequences of a default can [never] be a reasonable excuse for that default*'. His belief that the matter was closed after the initial penalties was not reasonable in the circumstances, though he would have filed earlier had he realised this penalty could be incurred. The FTT also declined to reduce the penalty by the amount of all previous penalties, rejecting his argument that imposing separate penalties for late filing and late payment was a breach of natural justice.

*M$^{c}$Cabe v HMRC* [2019] UKFTT 269 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07108.html*

### 2.6 Failure to take corrective action on receipt of a follower notice was reasonable.

*A taxpayer who had participated in Working Wheels had instructed his accountant to settle his tax position, which he paid. The FTT found that failing to take corrective action following a follower notice in these circumstances was reasonable.*

The taxpayer had taken part in the failed tax avoidance scheme known as 'Working Wheels'. He had been issued with a follower notice and an accelerated payment notice for £191,803 which, both parties subsequently agreed considerably overstated the correct liability of £16,580. This was because the notices were based on the premise that HMRC had previously accepted the losses created by the scheme but that was never in fact the case.

The taxpayer instructed his adviser to settle his tax position, which the accountant did, but he did not return the form attached to the follower notice that would have meant he would have taken corrective action as required by the follower notice.

HMRC issued a hefty £58,826 penalty based on 30% of the tax due in his closure notice. This was later slightly adjusted to reflect the amount on the accelerated payment notice.

There were disputed factual issues, but the judge decided that the taxpayer had failed to take corrective action as required. She was able however to find that the failure to do so was reasonable in the circumstances and therefore set aside the penalty. The taxpayer had made no attempt to obtain the blocked repayment; he had accepted his closure notice; he did not take steps to relitigate the matter. He had done what he thought necessary to settle the dispute with HMRC. His actions were therefore those of a reasonable person in his position.

*Corrado v HMRC [2019] UKFTT 275 (TC)*

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07114.html*

## 3. Business tax

### 3.1 FTT rules on SDLT anti-avoidance provisions

*A taxpayer has lost an appeal against a SDLT charge on the acquisition of a property involving a pre-sale restructure. The FTT found that the restructuring constituted a series of transactions that had a main purpose of achieving an SDLT saving. The judgement suggested that the outcome might have been different had the restructuring steps been undertaken in a different order.*

The case involved the transfer of a large commercial property that was held in an offshore unit trust structure. SDLT was self-assessed on only 1% of the consideration of the transaction. The buyer, a German partnership, wished to acquire the property separately from the English partnership that owned it to avoid potentially acquiring historic liabilities. The pre-sale restructuring therefore involved an initial transfer to a German company, which transferred it on to the German partnership. The subsequent sale of the unit trust was treated as free of SDLT.

HMRC took the view that the overall transfer fell afoul of the anti-avoidance provision in FA2003 s.75A. This provision operates when the SDLT liability on a series of transactions is lower than that which would have resulted from a direct notional transfer from the vendor to the acquirer. The taxpayers argued that s.75A should not be triggered unless the transactions when taken as a whole had not been taxed appropriately for SDLT purposes.

The FTT applied s.75A in accordance with the recent decision in *Project Blue v HMRC*: s.75A will operate where there is a reduced SDLT liability arising on a series of transactions, regardless of the motives driving those transactions. The taxpayers' case was therefore rejected. The FTT found that the steps in the transaction were commercially interdependent and had been intended to achieve the transfer of the property from the vendor to the German partnership. The notional transaction was therefore between the English and German partnerships, and SDLT of over £5m was imposed.

*Hannover Leasing Wachstumswerte Europa Beteiligungsgesellschaft MBH and another v HMRC* [2019] UKFTT 0262 (TC): *www.bailii.org/uk/cases/UKFTT/TC/2019/TC07102.html*

*Project Blue Limited v HMRC* [2018] UKSC 30: *www.bailii.org/uk/cases/UKSC/2018/30.html*

## 3.2 FTT clarifies the operation of Industrial Buildings Allowances (IBAs)

*The FTT has ruled that an industrial building can only be temporarily in disuse if it was used as an industrial building both before and after the period of disuse. The owner's intention to bring the building back into industrial use was irrelevant; the disuse was a question of fact. Although this approach may require a longer lookback period than was allowed for amending tax returns this was not reason enough to adopt a different approach from that set out in the legislation. The relevant law has since changed.*

The taxpayer was the nominated member of a Limited Liability Partnership that acquired an industrial site with the intention of developing and letting it. After a series of failed tenancy bids, the buildings on the site were demolished without having been let for more than one week. The business claimed IBAs on the site on the basis that it satisfied the definition of industrial buildings temporarily in disuse. It argued that the definition of temporary disuse was satisfied because it had intended the buildings to be brought back into industrial use. The decision to demolish the buildings was therefore a balancing event and gave rise to balancing allowances. HMRC disallowed the claims. It took the view that temporary disuse is a question of fact: a building can only be in temporary disuse if it is actually brought back into use.

The FTT agreed with HMRC. It acknowledged that the legislation did not cope well with extended periods of temporary disuse, because there was no mechanism to address claims where the time limits for amending a return had passed. This practical difficulty was, however, not sufficient to overturn the clear meaning of the statute.

IBAs were abolished in 2011.

*Mark Shaw (as nominated member of TAL CPT Land Development Partnership LLP) v HMRC* [2019] UKFTT 0280 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07119.html*

## 3.3 UT overturns FTT decision on just and reasonable profit apportionment

*The UT has agreed with HMRC that the FTT erred in law in its decision on whether or not an alternative profit apportionment basis was just and reasonable. The FTT failed to consider the result of the alternative profit allocation: it must be limited to what is necessary and sufficient to ensure that the apportionment was just and reasonable.*

The taxpayers operated several oil fields in the North Sea that were badly damaged in a severe storm, significantly reducing profits in the second half of 2011. In the same year, the supplementary CT charge rate on oil and gas production was increased from 20% to 32%. Companies with open accounting periods at the date of the rate change were allowed to treat the periods before and after the rate change as two separate accounting periods, and to allocate the profits between those periods. The default method of profit allocation was a time apportionment basis, but a company could use a different method if time apportionment gave rise to an unreasonable or unjust profit. The taxpayers elected to calculate the supplementary charge on profits for the 2011 on an actual basis in their respective corporation tax returns as a time apportionment basis for profits would have been unfavourable for both companies.

The FTT ruled that this alternative apportionment basis was just and reasonable. On appeal, however, the UT found that the FTT had made an error in law: it had not considered whether or not the alternative basis was limited to what was necessary and sufficient to ensure the apportionment was just and reasonable. The basis of apportionment used by the taxpayers reallocated more profit into the months before the supplementary charge rate increased than was justified by the timing and impact of the actual events.

*HMRC v Total E&P North Sea UK Limited and another* [2019] UKUT 0039 (TC)

*www.bailii.org/uk/cases/UKUT/TCC/2019/133.html*

## 3.4 FTT rules that a property development did not amount to a trade

*An offshore company has been denied ATED relief on the basis that, though it was developing a property, that activity did not amount to a property development trade. The absence of financial planning in the board minutes, lack of company accounts, and failure to register for UK CT suggested that the company was only developing the property to maximise the return on a disposal.*

The company had failed to sell a property and decided to redevelop it to make it more attractive to buyers and achieve a higher return. It took the view that the commencement of development works amounted to the commencement of a property development trade, and claimed ATED relief accordingly. HMRC denied the relief on the basis that the development work was not a property development trade.

The FTT found that the transaction was not carried on in a way typical of a property development trade. The 'badges of trade' were considered but did not point to a definitive result. The board minutes, however, did not discuss the expected costs or profits of the development, accounts had not been prepared, and there was a clear absence of financial planning. The company had also not registered for UK CT, which, though not conclusive evidence in and of itself, suggested that the directors had not been acting in a manner consistent with operating a trade.

For completeness, the FTT went on to find that the definition of 'property development trade' should be construed disjunctively, rather than conjunctively. The definition *'buying and developing for resale residential or non-residential property'* consists of two parts: buying property without a specific intention and then developing it for resale, rather than buying property for resale and then developing it for resale.

*Hopscotch Limited v HMRC* [2019] UKFTT 0288 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07127.html*

## 3.5 FTT finds unreasonable actions did not taint earlier actions

*The taxpayer had received a notice from HMRC that required it to start withholding tax on payments to a subcontractor under the Construction Industry Scheme (CIS). It continued to pay the subcontractor gross because the notification was delayed in the post. Although the company should reasonably have contacted HMRC when the letter was received, it did not act unreasonably by continuing to make gross payments before the letter arrived.*

The company provided contractors to construction companies and made payments under the CIS. HMRC wrote to the company to notify it that one of the subcontractors should be paid net of tax for all future payments. In disagreement with HMRC, the FTT found that the letter had been delayed in the post for four weeks. In that time, the company continued to make gross payments to the subcontractor. When the letter was received, the company did not contact HMRC to raise the issue of the delay or of the payments that had been made gross in the intervening period. HMRC has the authority to direct that the contractor is not liable to make payment for the tax withheld if the contractor took reasonable care to comply with the law and the failure to withhold tax was due to an error made in good faith. HMRC argued that the company had not acted reasonably or in good faith.

The FTT held that the company was only required to act reasonably at the time it made the payments. It was not reasonable to fail to contact HMRC once the letter had been received, but this could not retrospectively affect the reasonableness of the company at the time of payment. The payments were also clearly in good faith since the notification had not been received. The appeal was upheld and the company was granted a direction that the tax need not be paid to HMRC.

*Ground Force Construction Limited v HMRC* [2019] UKFTT 0274 (TC)

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07113.html*

# 4. VAT

## 4.1 ATT warns over MTD penalties for early adopters

*Businesses which have adopted MTD early are at risk of late filing penalties. HMRC is not expected to give exemptions.*

The ATT has warned that businesses which have signed up to MTD voluntarily, before it becomes compulsory, may face problems with filing their first MTD return if they are not using compliant software. Any business to which this applies should ensure they pay the VAT on time, and contact the software provider and HMRC as soon as possible.

HMRC will take a light touch approach to penalties for record keeping for the first year, but is not expected to do so for late filing or late payments.

www.att.org.uk/technical/news/press-release-penalty-warning-those-who-enrolled-too-early-making-tax-digital

## 4.2 Appeal allowed in part on zero rated approved alterations to a listed building

*The FTT has clarified the distinction between 'alterations' and 'repairs and maintenance' for the purposes of zero rated VAT treatment. Works can only be classified as repairs if they are minimal in nature.*

The taxpayer was the main contractor engaged to carry out extensive restoration works to a listed cottage that had suffered significant fire damage. The works were approved by the local council and the taxpayer treated them as approved alterations to a listed building. Such alterations are zero rated under the transitional arrangements following a change of legislation in 2012. HMRC raised assessments on these transactions, claiming they did not qualify as alterations but were instead repairs and maintenance works.

This argument was made on the basis that 'alterations' and 'repairs and maintenance' are not mutually exclusive; construction works can comprise both. Zero rating was, therefore, not applicable.

The FTT held that most of the alterations were too substantive to be classed only as repairs. A reduction to the assessment raised by HMRC was granted. This decision was made in accordance with the decision of *Viva Gas Appliances*: for the alterations to be classified as repairs they should be only minimal in nature. The rewiring works were classed partly as repairs and partly as alterations. An apportionment between these classifications was agreed between HMRC and the taxpayer.

*Cube Construction (Southern) Ltd v HMRC* [2019] UKFTT 180 (TC)

*Commissioners of Customs and Excise v Viva Gas Appliances Ltd* (HL) [1983] STC 819, [1984] 1 All ER 112

*www.bailii.org/uk/cases/UKFTT/TC/2019/TC07030.html*

# 5. Tax publications and webinars

## 5.1 Briefing Notes published

*The following Briefing Notes have been published*

*Taxation of gains on disposals of UK property by non-residents*

# 6. And finally

## 6.1 Aye, right!

In the legislation providing for the Scottish Rate of Income Tax there is but one rule for automatic residency: Members of the Scottish Parliament (MSPs) are automatically resident in Scotland, irrespective of their address. Not a particularly complicated rule, especially compared to the wealth of intricacies and seemingly arbitrary rules of tax (read: VAT). And yet, over one third of Scottish parliamentarians were

classified as non-Scottish taxpayers when their 2019/20 tax codes were issued. HMRC, presumably by way of reassurance, explained that the problem arose because the automated systems cannot handle the different residency treatment, so these tax codes were instead entered manually. Far from setting our minds at ease, this comment in fact causes us more incredulity: is it really the case that the HMRC employee responsible for entering the tax codes for MSPs couldn't correctly identify them as Scottish?

Well; perhaps, perhaps not; and they might be feeling a bit hard done by. But at least they are not on Brexit duty.

*www.parliament.scot/S5_Public_Audit/General%20Documents/2090321JH_letter_to_PAPLS.pdf*

| Glossary | | | | |
|---|---|---|---|---|
| *Organisations* | | *Courts* | *Taxes etc* | |
| ATT – Association of Tax Technicians | ICAEW - The Institute of Chartered Accountants in England and Wales | CA – Court of Appeal | ATED – Annual Tax on Enveloped Dwellings | NIC – National Insurance Contribution |
| CIOT – Chartered Institute of Taxation | ICAS - The Institute of Chartered Accountants of Scotland | CJEU - Court of Justice of the European Union | CGT – Capital Gains Tax | PAYE – Pay As You Earn |
| EU – European Union | OECD - Organisation for Economic Co-operation and Development | FTT – First-tier Tribunal | CT – Corporation Tax | R&D – Research & Development |
| EC – European Commission | OTS – Office of Tax Simplification | HC – High Court | IHT – Inheritance Tax | SDLT – Stamp Duty Land Tax |
| HMRC – HM Revenue & Customs | | SC – Supreme Court | IT – Income Tax | VAT – Value Added Tax |
| HMT – HM Treasury | | UT – Upper Tribunal | | |