

PRACTICE UPDATE

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Terms of Engagement

Please note that our standard Terms of Engagement changed on 1 January 2012. Current Terms of Engagement are available at: www.markmclaughlin.co.uk/index.php/archives/49

1. Private residence relief

The Capital Gains Tax (CGT) relief on disposal of an individual's only or main residence is very valuable and well known. Taxpayers are generally aware of the need to reside in the property, which is a fundamental requirement for principal private residence (PPR) relief. However, what degree of permanence and continuity is necessary to qualify for PPR?

In *Clarke v CRC* [2011] UKFTT 619 (TC), HMRC raised assessments on the taxpayer, on the basis that he was not entitled to PPR relief in respect of two properties. Prior to purchasing those properties, he lived at the matrimonial home with his wife and two daughters. Following marital difficulties, he purchased a property (Property 1) on 17 July 2002, improved it and moved in with his eldest daughter. He considered Property 1 to be his PPR from the time of moving in (as soon as he completed on the property), and had acquired it with a view to permanently leaving the matrimonial home. He used a twelve month business loan from Nat West bank, as this was the fastest and cheapest route for him to raise the necessary funds.

The taxpayer subsequently developed land attached to Property 1. He obtained planning permission to build Property 2 on 15 November 2002. In order to raise funds

to do so, Property 1 was put on the market in December 2002 and sold in March 2003. The taxpayer then stayed at his mother's house. He started work on Property 2, and began living there in July 2003. In July 2005, his wife attempted to commit suicide, and he moved back to the marital home to protect his children. Property 2 was put on the market, and was sold in November 2005. The former matrimonial home was subsequently sold, and the taxpayer went to live in a converted house with his children.

HMRC submitted that at no time in the period of ownership was either of the two properties the taxpayer's only or main residence. HMRC also argued that there was no intention to live permanently in either property, and no evidence had been provided to show any degree of permanence or continuity.

The tribunal considered the circumstances of the case, and found that when the taxpayer moved into Property 1 he intended to live there permanently. There had been a necessity to move out of the marital home. The twelve month business loan from Nat West had been the fastest and cheapest route for the taxpayer to raise the funds to purchase the property, and his intention was to sell the land attached to the house to pay off the bank loan. The tribunal also found it credible that after planning permission was

obtained he decided to develop Property 2 himself, and accepted that he had to move back to the marital home after the suicide attempt by his wife. The tribunal held that the taxpayer was entitled to PPR relief in respect of the two properties, and allowed his appeal.

Permanence and continuity

When considering whether an individual potentially qualifies for PPR relief on the disposal of a dwelling house, HMRC appears to look at certain fundamental issues. Firstly, did the individual occupy the property as his or her only or main residence; secondly, if (s)he did reside in the property, was there a degree of permanence and continuity to indicate that the individual intended to occupy the property as his or her home.

On the 'occupation' issue, it should be noted that the PPR relief provisions allow certain 'deemed' periods of occupation, such as the last 3 years' ownership. However, the dwelling house must have been physically occupied as the individual's residence at some time during his period of ownership to qualify for relief. HMRC considers that an intention to occupy is not enough (CG64465).

With regard to HMRC's 'permanence and continuity' requirement, HMRC appears to derive this requirement from (non-PPR relief) case law on the meaning of 'residence', and on the judgment in the PPR relief case *Goodwin v Curtis* [1998] STC 475. In that case, the taxpayer had only lived in a farmhouse for 32 days. It was held that he had not intended to occupy it as his permanent residence.

In the *Clarke* case, HMRC accepted in correspondence that the appellant resided at Property 1, but argued that he did not intend to live in either of the properties permanently. HMRC also argued that there was no evidence of continuity. Fortunately, the tribunal found in favour of Mr Clarke on this point.

HMRC will no doubt state that each case is based on its particular facts. However, the *Clarke* case suggests that PPR relief

may be available after relatively short periods of ownership and occupation. Clear evidence of occupation and intention to reside at the dwelling house permanently should be gathered and retained, particularly in borderline cases.

2. Share loss relief

It is probably a sign of the present hard economic times that more taxpayers seem to be seeking tax relief for losses on investments in shares and business loans. This is reflected in the number of cases reaching the tax tribunal.

Tax relief claims for losses against capital gains are prevalent. However, such relief generally only shelters gains at rates of up to 28%. By contrast, loss relief against income potentially provides income tax relief at rates of up to 50%, and is therefore the preferred route for many individuals.

The provisions allowing individuals to claim relief for losses on disposal of shares against general income (ITA 2007, ss 131-151) are subject to a number of conditions. For example, the shares must be 'qualifying shares', i.e. either shares to which enterprise investment scheme relief is attributable, or shares in a qualifying trading company which were subscribed for by the individual (ITA 2007, s 131(2)).

In *Halnan and Squire v CRC* [2011] UKFTT S80, HM Revenue and Customs (HMRC) disallowed the taxpayers' claims for an allowable loss for 2004-05 (under what was then ICTA 1988 s 574), in respect of a close company of which both were directors. The taxpayers appealed.

The points at issue were whether the taxpayers were entitled to claim income tax loss relief in respect of the shares. The company ceased to trade on 31 October 2004, and a liquidator was appointed. Both taxpayers had agreed to provide £50,000 to the company at a meeting in May 2004. However, they were unable to produce share certificates, and there was no contemporaneous note of the meeting in which the share purchase was said to

have been discussed, agreed and allocated to them. There was no record of the share purchase at Companies House, and the directors were unable to produce the company's register of members.

The taxpayers argued that the affairs of a small private company are often conducted informally, and that the absence of share certificates and other evidence of shares being issued was not fatal to their arguments. The tribunal accepted that a subscription of the shares was discussed at a meeting of the company, and that the taxpayers each added £50,000 to the company. However, the burden of proof in respect of the shares was on the appellants. HMRC disputed that the appellants subscribed for shares for the purposes of ICTA 1988, s 574 (the share loss relief provisions), and stated that there was no evidence to support this.

The tribunal reviewed the available evidence. The taxpayers had acknowledged that shares would only be subscribed for the purposes of the share loss relief rules if the company had an obligation to issue the shares as a result of receiving the payments. A letter (from a consultant to the company) had been provided as evidence of what had happened at the above meeting in May 2004, but the tribunal considered that at most this only evidenced what two of the three company directors intended at the time (the third director was not present at the meeting).

The tribunal held that although they were directors of the company, there was no suggestion that they left the meeting committed to provide funds to the company, nor that the company was bound to issue further shares to them upon receiving payment, as certain other matters remained to be resolved, including the position of the third director and the raising of further funds required from third parties. The taxpayers' appeal was dismissed.

Close companies

The taxpayers certainly had a point when arguing that small ('close') company matters are often dealt with on an informal basis. That has certainly been my experience of dealing with such companies over the years. Unfortunately, the lack of documentation such as board minutes or written agreements has the potential to cause difficulties, as illustrated in the above case.

HMRC cited the case *National Westminster Bank PLC v CIR* as providing guidance on what constitutes the 'issue' of shares (the inference being that shares are issued when allotted and recorded in a share register). However, that case concerned a public limited company. The tribunal in *Halnan and Squire* commented in the context of a small company. "We can see that a degree of informality is to be expected compared with say, the company whose shares were relevant in the Natwest case."

The taxpayer had argued that *Blackburn and anor v RCC* [2009] STC 188 (an Enterprise Investment Scheme case) was helpful and relevant, as it considered the meaning of 'issue'. The taxpayer in that case made a number of payments to a company. The Court of Appeal had to consider the status of those payments, and decide whether they were made for the allotment of shares.

The tribunal in *Halnan and Squire* distinguished the facts of that case on the basis that in *Blackburn* there had been a prior course of share dealing, and the taxpayer had taken advice from his accountant about making payment for the shares. However, in *Blackburn* the taxpayer's initial payment to the company prior to the history of share dealing and before taking advice from his accountant was held not to be eligible for relief. The tribunal in *Halnan and Squire* considered that the payments had a similar profile to the non-eligible payment in *Blackburn*.

Thus if making a claim for share loss relief (or indeed any claim for relief) it is clearly important to ensure that there is sufficient evidence to substantiate the claim. Such

attention to detail can easily be overlooked in the case of small, family or owner-managed companies, but could be crucial to a claim.

The legislation allowing relief for losses on the disposal of shares against general income can be difficult, depending on the circumstances. Attention to detail is important not only in terms of the company's administration, but also in ensuring that the relief conditions are satisfied and a valid claim is made.

3. HMRC Enquiries

Most tax agents involved with enquiry work will be familiar with the HMRC practice of 'spreading'. This generally occurs when there is an agreed addition to the taxpayer's income for the year of enquiry. HMRC will often seek to assess similar additions in earlier years, and sometimes to agree additions for later years as well. This is on the basis of a 'presumption of continuity', i.e. that the taxpayer's default for the year of enquiry was continued in other tax years as well, unless there is evidence to the contrary.

HMRC points to case law in support of 'spreading' in its Enquiry Manual (see EM3310). Probably the most well-known of these cases is *Jonas v Bamford* [1973] STC 519. In that case, Judge Walton J expressed the presumption of continuity as follows:

"...once the inspector comes to the conclusion that, on the facts which he has discovered, Mr Jonas has additional income beyond that which he has so far declared to the Inspector, then the usual presumption of continuity will apply. The situation will be presumed to go on until there is some change in the situation, the onus of proof of which is clearly on the taxpayer."

HMRC encourages its enquiry staff to use spreading where it is considered to be appropriate (EM3309). For example:

"...if you have proven omissions for which there is no ready explanation and the business and way of life of the taxpayer

have not changed you will be in a much stronger position to argue for addition to other years."

In addition to applying the concept of spreading to assess additional income for other years, it seems that HMRC will also seek to disallow expenses on a similar basis.

In *Syed v Revenue & Customs* [2011] UKFTT 315 (TC), HMRC amended the taxpayer's return for 2005/06 following an enquiry, and raised discovery assessments for the tax years 2001/02 to 2004/05 inclusive, and for 2006/07. HMRC sought to increase the taxpayer's profits for 2005/06 as a dentist, not only in respect of unrecorded income, but also by disallowing certain expenses (e.g. repairs, legal and professional costs and interest paid). HMRC's adjustments going back to 2001/02 and forward to 2006/07 were made on the assumption that the errors identified for 2005/06 had been repeated in the other years. The taxpayer's appeals against the assessments were dismissed. The tribunal held that there was no evidence to suggest that the adjustments for disallowed costs were wrong (and there was also insufficient evidence that the additional income was not business income).

The decision in *Syed* is worrying, because it indicates that accepting (say) the disallowance of an item of business expenditure during the course of an enquiry will require careful thought, due to the potential for HMRC to apply spreading and seek adjustments in respect of other tax years.

Limitations

However, there have been indications that the presumption of continuity may be more limited in its scope than HMRC perhaps consider it to be. For example, in the *Syed* case the tribunal made the following comments about the application of the principle established in *Jonas v Bamford*: *"In our view [the above quotation by Walton J] expresses no legal principle. It seems to us that it would be quite wrong as a matter of law to say that*

because X happened in Year A it must be assumed that it happened in the prior year.” The tribunal added:

“In practice it will generally be reasonable and sensible to conclude that if there was a pattern of behaviour this year then the same behaviour will have been followed last year. Sometimes however that will not be a proper inference: there will be occasions when the behaviour related to a one off situation, perhaps a particular disposal, or particular expenses; in those circumstances continuity is unlikely to be present.”

In addition, it should be noted that the Judgment of Walton J in *Jonas v Bamford* indicates that the presumption of continuity, on the basis of that case, applies to the future and not the past.

Back and forth

Backwards and forwards spreading was at point in *Chapman v Revenue & Customs* [2011] UKFTT 756 (TC). In that case, the taxpayer appealed against assessments for 2004/05 to 2007/08. The enquiry year was 2006/07. In the absence of adequate business records, HMRC conducted a ‘takings build-Up’ exercise. HMRC considered that the retail price index should be applied to calculate the shortfall in declared income for 2004/05 and 2005/06, and the later year of 2007/08.

However, the tribunal noted that virtually all the evidence presented related to the period covered by the year of enquiry. With regard to HMRC’s takings build-up exercise, the tribunal noted that it was only an estimate, and held that the resulting turnover figure was “wholly unrealistic.” The omitted sales figure for 2006/07 was reduced accordingly. The tribunal also noted that a takings build-up was not produced for 2004/05 or 2005/06 due to “time constraints”, and commented: “...we cannot endorse such an approach in this case where the takings build-up relies on a number of specific transactions peculiar to the enquiry year”.

The tribunal added in the context of business economics exercises generally: “Where a capital statement is prepared for

one year and sought to be applied to other years, they have to be adjusted to take account of exceptional items peculiar to the particular year. That was not done here”. The tribunal concluded that the assessments therefore could not stand, and that because there was no basis on which to substitute other figures, the assessments must be reduced to nil. Similarly, the tribunal held that HMRC’s takings build-up calculation for 2007-08 seemed arbitrary, and therefore could not stand. The assessment for that year was also reduced to nil.

The presumption of continuity was also considered recently in *The Red Star v Revenue & Customs* [2011] UKFTT 812 (TC). In that case, following an into a partnership return for 2005/06, HMRC considered that there had been a suppression of sales and profit at the partnership’s Chinese takeaway restaurant business. HMRC adjusted the sales and profit figures for 2005/06 based on the quantities of rice used in the business. Applying the presumption of continuity, HMRC then adjusted the profits for all the other tax years from 2002/03 to 2007/08 to the same figure, subject to rounding, an inflationary adjustment and time apportionment for the final period of trading in 2007-08 of less than a year.

However, the tribunal was not satisfied that the presumption of continuity applied in the way that HMRC had sought to apply it. The tribunal considered that HMRC should have amended partnership profits for earlier years not by simply substituting an inflation adjusted figure carried back from 2005-06, but by applying the same methodology used in arriving at the 2005-06 figure, and assuming the same degree of under-declaration of both sales and purchases. With regard to later years, the tribunal commented that if proper partnership returns had been made for those years, the retirement of the senior partner during 2006 would have been sufficient to displace the presumption of continuity. However, as the partnership returns for 2006-07 and 2007-08 were estimated, the profit figures for those tax years were amended based on the

revised 2005-06 figure, subject to an adjustment for inflation and time-apportionment for the cessation period.

Conclusion

Taxpayers who are subject to 'spreading' in HMRC assessments of additional income following an enquiry should be prepared to challenge HMRC's calculations in appropriate circumstances, particularly where there is evidence to indicate that a presumption of continuity is not the correct approach based on the facts and particular circumstances of the case. Whilst the tribunal decision in *Chapman* offers taxpayers some encouragement it does not create a binding precedent, and further guidance regarding the limitations of the presumption of continuity would therefore be welcomed.

4. HMRC: Time to Pay

Most tax professionals and many taxpayers will be familiar with the concept of 'time to pay' (TTP) arrangements with HM Revenue and Customs (HMRC). The basic position of HMRC is that tax is payable when due by law (note - the tax legislation does allow certain tax liabilities to be paid by instalments, but such instances are relatively uncommon). However, HMRC has some discretion (under a general responsibility of collection and management of taxes etc in the Commissioners for Revenue and Customs Act 2005) to allow payment after the due date, in the form of TTP arrangements.

HMRC issued a 'briefing' in October 2011, 'Giving taxpayers time to pay' (www.hmrc.gov.uk/about/briefings/index.htm). HMRC's basic conditions for TTP are:

- HMRC is satisfied that the taxpayer is genuinely unable to pay their tax on time;
- The taxpayer can keep up with the payments they are offering to make;
- Other tax bills are capable of being paid as they arise;
- Any outstanding tax is paid off as quickly as possible

TTP arrangements will not be agreed solely to stop a business from going bankrupt, where HMRC is the major creditor and the business is relying on not paying its tax to stay afloat. Nor will HMRC agree TTP only to project jobs or a particular activity or industry.

Is that so?

HMRC denies that it has 'tightened up' on TTP. Instead, HMRC blames an increase in the proportion of TTP applications not meeting the above conditions, e.g. businesses which have had a succession of TTP arrangements, or which have failed to keep up the terms of previous arrangements. Refusals in 2011 (up to the end of August) represented 14% of total applications.

Despite HMRC's claims to the contrary, there is anecdotal evidence that HMRC is taking an increasingly tougher line. Firms have outlined to me instances where HMRC has by-passed them as agent and contacted the taxpayer directly to pursue outstanding tax liabilities. I also recently queried with my local 'Working Together' group in Manchester whether HMRC is denying TTP arrangements where companies have a history of dividend payments (as had previously been reported on AccountingWeb). Whilst it was agreed that this matter would be 'escalated' to a higher level, HMRC has yet to reply or make any official announcement of its policy on this issue at the time of writing to my knowledge.

Official guidance

HMRC devotes a whole section of its Debt Management and Baking Manual to time to pay arrangements. HMRC generally seeks to distinguish between taxpayers who 'can't pay' and those who 'won't pay' – TTP arrangements may be extended to the former but not the latter. TTP arrangements typically span a few months or possibly longer (e.g. for business taxes), although TTPs lasting over a year are only agreed in "exceptional cases" (DMB800040). Interest will invariably be charged whether TTP is agreed or not.

Guidance on how HMRC distinguishes between 'can't pay' and 'won't pay' taxpayers is included at DMBM800050. In general, it is good practice before speaking to HMRC about TTP arrangements to read their guidance on the subject, and to ensure that HMRC's staff adheres to their own guidelines without imposing further conditions for TTP.

Late Payment penalties

The HMRC briefing on TTP states that if an arrangement is agreed, HMRC will remove any surcharges or penalties that would otherwise have arisen, where TTP is agreed before any surcharges or penalties become due.

It should be noted that this treatment is statutory, not concessionary. Under the recently introduced penalty regime for late tax payments, the law requires that HMRC must suspend late payment penalties if certain conditions are satisfied (FA 2009, Sch 56, para 10) (Note - a similar rule applies in respect of the late payment surcharges regime applicable to tax returns up to and including 2009/10, where the TTP arrangement was made on or after 24 November 2008 (FA 2009, s 108)). These conditions are broadly as follows:

- The taxpayer must approach HMRC before becoming liable for the penalty;
- HMRC must agree to the 'time to pay' arrangement; and
- The taxpayer must adhere to the agreement and comply with any conditions of the arrangement.

If the taxpayer breaks the agreement (i.e. by defaulting on payment of the tax, or by failing to comply with any conditions of the time to pay arrangement) HMRC may impose the suspended penalty.

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3. Ray & McLaughlin's Practical IHT Planning (Bloomsbury Professional)



Practical Inheritance Tax Planning, 10th edition (Mark McLaughlin, Geoffrey Shindler, Paul Davies and Ralph Ray)

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