PRACTICE UPDATE

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1. Management charges

The use of management charges between related businesses is a relatively popular and well-known tax planning technique. Management charges are often considered if, for example, companies are 'associated' for small companies' relief purposes to minimise tax liabilities by ensuring that more profits are subject to a lower rate of corporation tax overall.

There is some degree of acceptance of commercial levels of management charge in HMRC guidance, in the context of groups of companies (see BIM38230). In addition, HMRC acknowledges the use of service companies by partnerships, where the service company provides office accommodation and clerical services. However, in this case HMRC's view is that the management charges to the partnership should not be more than their cost plus a "modest uplift", stating that "As a broad rule of thumb a modest uplift would be in the region of 5%" (BIM72070).

HMRC's approach is probably based on the decision in *Stephenson (HMIT) v Payne, Stone, Fraser and Co* [1968] 44 TC 507. In that case, a firm of Chartered Accountants used a service company to provide the firm with staff, facilities etc. The firm agreed to pay the service company £47,000 in one accounting year, although the services rendered in that year cost only £32,000. The Revenue refused to allow the whole of the £47,000 in the relevant year, contending that no more than £32,000 fell to be deducted from profits for the year. The High Court held that only £32,000 of the expenditure, plus a 'nominal profit' for the Service Company, could properly be deducted in that year.

Avoiding pitfalls

Problems can arise if management charges appear excessive or non-commercial, or if the charges are intermittent or vary widely. To qualify as an allowable deduction for the paying company, management charges must satisfy the normal tests of being revenue expenditure incurred wholly and exclusively for the purposes of the company's trade.

HMRC is understood to be challenging management charges in some cases by applying 'transfer pricing' principles. There is anecdotal evidence that this has sometimes resulted in deductions being restricted or denied for the paying entity, whilst remaining taxable in the charging company. HMRC has also been known to argue that management charges are 'disguised' remuneration of controlling directors, with a view to imposing PAYE Income Tax and NIC liabilities thereon. In addition, management charges can give rise to VAT problems, as well as company law issues (both of which are beyond the scope of this article).

What can be done?

It should help in any negotiations with HMRC if it can be demonstrated that the management charge has been calculated on a reasonable and commercial basis.

The basis of charge should be properly documented in an agreement between the entities governing the provision of the management charges. The charges should also preferably be consistent from one accounting period to another, and be invoiced at regular intervals. Above all, it is important to remember that there must be a valid basis for the charge, not simply dealing with business profits in a tax-efficient way.

2. Employment status

The issue of whether a worker is employed or self-employed is often unclear. This uncertainty has resulted in a number of Court cases over the years. From those cases various indicators have been established, pointing towards either a contract of service (employment) or a contract for services (self-employment). Treating a worker's employment status correctly is important because if a business treats a worker as self-employed when he is really an employee, the tax risk falls on the business, not the worker.

The ESI tool

Fortunately, it is possible to achieve certainty on the employment status of workers in many cases. HMRC's website features an 'Employment Status Indicator' (ESI) tool (www.hmrc.gov.uk/calcs/esi.htm), which enables the employment status of an individual or group of workers to be checked for Income Tax, National Insurance contributions (NICs) or VAT purposes.

The ESI tool provides an indication of a worker's employment status based on responses given to a series of questions. The ESI response can be relied upon as evidence of a worker's status if:

- The answers given accurately reflect the terms and conditions of the worker's services; and
- The ESI has been completed by the 'engager' or their authorised representative.

However, HMRC states that if the worker completes the ESI tool, the result given is only 'indicative'.

The fact that HMRC will rely upon the ESI tool in the circumstances described above potentially gives taxpayers the best of both worlds. If the tool provides the 'right' answer for the worker, HMRC will be bound by the outcome if copies of the 'Enquiry Details' and 'ESI Result' Screens are printed or saved and retained in case the worker's employment status is questioned by HMRC in the future.

On the other hand, the worker is not necessarily bound by the ESI tool's decision if he or she does not like it. The tool provides information on how it arrived at its decision, which can be helpful. For example, in some cases it may be possible for the terms and conditions of the worker's engagement to be changed to accord with their preferred employment status. However, it is clearly important that those terms and conditions reflect the true facts of the worker's engagement.

Limitations

The ESI tool is not without its limitations. It cannot be used to check the employment status of some workers, including company directors and other office holders, agency workers, entertainers and those providing services through an intermediary (i.e. potential IR35 situations). In addition, the ESI tool does not always give a definite answer. Nevertheless, it can be a useful form of protection in employment status disputes with HMRC.

What else can be done to protect businesses engaging workers who are potentially subject to an employment status dispute? Engaging the worker through a Personal Service Company (PSC) may provide protection in appropriate cases, as the tax risk moves from the engager to the PSC under the IR35 rules. There should be a written contract in place between the engaging business and the PSC. It is also important that the paperwork reflects the true facts

of the working relationship between the parties, to reduce the risk of challenge from HMRC.

3. Negligible value claims

An unfortunate effect of the recession has been an apparently increasing number of capital losses on assets. A negligible value claim (under TCGA 1992, s 24) is a useful mechanism to realise an allowable capital loss. In cases involving qualifying shares, the loss can be converted to an income tax loss and offset against general income (ITA 2007, ss 131-151).

The effect of a negligible value claim is broadly that the taxpayer is treated as if he or she had disposed of the asset and immediately reacquired it for the amount specified in the claim. For the purposes of a claim, the deemed disposal and reacquisition takes place when the claim is made. Alternatively, the claim can specify an earlier date up to two years before the start of the tax year in which the claim is made (or for corporation tax purposes, from the first day of the earliest accounting period ending not more than two years before the time of the claim), provided that the asset was owned and had become of negligible value at that earlier time.

The owner of the asset may claim relief in two circumstances. The first is that the asset has become of negligible value during the taxpayer's period of ownership (the second circumstance deals with earlier no gain, no loss disposals, and is outside the scope of this article).

It can be difficult to prove that an asset has 'become' of negligible value. In *David Harper v CRC* [2009] UKFTT 382, the taxpayer made a negligible value claim and income tax loss relief claim in his 2003-04 tax return. The shares were of negligible value at the time of the claim (5 April 2004). However, the dispute was about their value when the taxpayer acquired them in June 2002 and December 2003. HMRC had refused to allow the negligible value and loss relief claims, contending that they were of negligible value at those times, and so did not 'become' of negligible value. Both sides in the case made submissions about the value of the company as at June 2002 and December 2003.

The tribunal pointed out that the burden of showing entitlement to tax relief lies with the taxpayer. Having considered the valuation evidence, the tribunal concluded that the calculations submitted on behalf of the taxpayer were "…based more on hope than experience", and that the shares did not 'become' of negligible value because they were always of negligible value. The taxpayer's appeal was therefore dismissed.

Supporting information

A feature of the above case was the apparent lack of evidence in support of the taxpayer's claim that the shares had become of negligible value. For example, the tribunal Judge pointed out that no evidence had been submitted about the company's turnover or profitability in December 2003. He held: "There is no reliable evidence from which we could properly conclude that the company had a positive value, reflected in its shares, at either of those dates, still less evidence from which we might come to a conclusion about what that value might have been."

The moral of the case is therefore to retain evidence of an asset's value at the time of acquisition, to demonstrate that the amount is not negligible. Valuation evidence is also required at the time of the claim, or at any earlier time specified in the claim, to demonstrate that the shares have become of negligible value. It may be possible to agree valuations with HMRC using the CG34 procedure (i.e. following or at the same time as a negligible value claim), if the self-assessment return for the relevant tax year has not yet been filed.

4. Discovery assessments

Taxpayers understandably want certainty about their tax affairs, and demand finality

when submitting their tax returns, that HMRC will be unable to make a 'discovery' outside the normal enquiry window. Unfortunately, there is invariably uncertainty when submitting returns about whether disclosures in it (normally in the 'white space') are sufficient to bring about the required finality.

In *Pattullo, Re Judicial Review* [2009] CSOH 137, the taxpayer sought judicial review in respect of a discovery notice issued by HMRC under TMA 1970, s 20(1). On 31 January 2005, the petitioner filed his 2004 tax return, which contained information in the 'white space' concerning a capital loss arising under a capital redemption contract arrangement (referred to as the 'CRC Mark II Scheme'). The issue was whether HMRC was entitled to make a discovery assessment under TMA 1970, s 29, and to serve a discovery notice.

It was argued for the taxpayer that the white space contained a full and detailed disclosure of what had happened. HMRC was therefore precluded from making a discovery assessment, and a discovery notice was ruled out. It was also argued that before a discovery assessment could be made, HMRC must discover something new, but no new matter was shown to have arisen.

Adequate disclosure

However, the Scottish Court of Session dismissed the taxpayer's application. Lord Bannatyne said that the taxpayer's right to finality is balanced by a taxpayer's duty to clearly alert HMRC to an insufficiency in the tax return. He stated:

"It is only if the taxpayer has made a return which has clearly alerted the officer to the insufficiency that it will be considered adequate and will shut out a section 29 discovery assessment."

The standard of information to be provided by the taxpayer is such "…that would be objectively understood by an [HMRC] officer of general knowledge and skill". Otherwise, HMRC can newly discover an insufficiency. Lord Bannatyne said that the onus then falls on the taxpayer to prove that HMRC has been clearly alerted to the insufficiency. He added:

"The full factual position would have included a statement that the petitioner was part of…a scheme and a full statement of the legal position would have included a statement of doubt or a statement that a contrary position to the HMRC was being insisted upon together with a clearer picture of the operation of the scheme."

This is clearly a very high standard of disclosure, which in practice will render a high proportion of tax returns open to possible discovery. If HMRC does raise a discovery assessment, it may ultimately become necessary for the taxpayer to demonstrate to the Tax Tribunal (on a balance of probabilities) that HMRC has been clearly alerted to a possible insufficiency in the return.

Further guidance

The Pattullo case follows some notable decisions concerning discovery, including *Langham v Veltema* [2004] STC 544 and *Corbally-Stourton v CRC* [2008] SpC 692. It includes useful commentary on earlier case law, and neatly summarises the components of an adequate disclosure. In addition, HMRC's views on achieving finality in self-assessment returns and avoiding discovery are contained in Statement of Practice 1/06.

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