

# PRACTICE UPDATE

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### 1. Loans to participators

Many business owners operate more than one business, often through different legal entities. This can sometimes lead to unexpected and unwelcome tax consequences.

#### Companies and partnerships

Care is needed if one of the businesses is a close company and the other business is a sole trader or partnership, where the unincorporated business owner is a 'participator' in the company. A loan or advance from the company to the sole trader or partnership can result in a tax charge as a 'loan to participator' under CTA 2010, s 455 (previously ICTA 1988, s 419), subject to certain exceptions (see below).

Where a section 455 liability arises, the tax position could potentially be exacerbated by the imposition of penalties for failure to take reasonable care. In the case of close company loans to directors generally, HMRC's guidance states (EIM8630):

"For the purposes of the Companies Acts, the accounts of a company are required to disclose loans or advances made to directors. Accounts that include loans or advances to participators under general headings, such as sundry debtors, may not be 'incorrect' accounts for tax purposes."

"An offence of submitting incorrect accounts would, of course, have been

committed if the loans had been, through fraud or negligence, wrongly described in the accounts by

- inclusion of a participator's loan account under 'trade debtors'. This is at least negligent..."

However, what if the participator is also a partner in a trading partnership? If the debt arises from trading transactions between the company and partnership, it is difficult (for me, at least) to see how including the debt under trade debtors can be negligent (or a failure to take reasonable care). Nevertheless, I have seen cases where HMRC inspectors have argued that loans to participators should be separately disclosed in the company's accounts, regardless of how the debt arose.

#### Exceptions

Of course, there is an obligation to notify HMRC about loans or debts to participators on the company tax return and to report any liability under section 455, unless certain specific exceptions apply. These include the following:

(a) Loans or advances in the ordinary course of a business carried on by a close company which includes the lending of money (s 456(1)); and

(b) Trading and business debts - Where the 'loan' is a debt (ie for goods or services supplied in the ordinary course of the company's trade or business), the charge does not apply unless the credit period exceeds six months, or is longer

than the credit period normally given to the company's customers (s 456(2)).

In the context of a close company loan to an individual participator in a partnership, the above exceptions provide a potential escape from a section 455 charge. However, in practice the company will rarely be carrying on a money lending business. In addition, trade or business debts incurred by the unincorporated business will often exceed the credit period allowed to other customers. HMRC's view is that a debt is incurred when goods are delivered or services performed, and credit runs from then until payment (CTM 61535; see also *Grant v Watton* 71 TC 333).

What if the lending company is a member of the partnership? Happily, HMRC will not contend that loans are within the charge under section 455 if there is a "genuine partnership", which presumably means a bona fide commercial arrangement (see CTM 61515).

### HMRC Toolkit

HMRC is releasing a 'Directors' Loan Accounts Toolkit' to assist in the preparation of company box returns, in terms of potential section 455 liabilities and repayments. However, it remains to be seen how useful the toolkit will be when dealing with debts incurred by a related business involving a participator.

## 2. Overpayment relief

Tax advisers will doubtless be familiar with 'error or mistake' claims. These claims broadly arise if a taxpayer has paid (or been assessed to) tax which they believe is not due.

Error or mistake claims were sometimes referred to as 'section 33 claims', because the statutory reference for the claim was in section 33 of the Taxes Management Act 1970. The replacement rules are in TMA 1970, Sch 1AB ('Recovery of overpaid tax') and apply from 1 April 2010. Section 33 in its amended form simply cross-refers to this new legislation. The

rules apply for income tax and capital gains purposes, where the tax paid was not due, or if HMRC has made an assessment or determination of tax which the taxpayer believes is excessive. The relief must be claimed within the statutory time limit of four years after the end of the relevant tax year (Sch 1AB, para 3(1)).

### Relief denied

No overpayment relief will be given in certain circumstances. These are listed in the legislation as Cases A to H. For example, Case A provides (among other things) that no relief is given for mistakes in a claim, election or notice.

Case C denies overpayment relief if the taxpayer has missed the time limit for seeking relief, and knew, or ought reasonably to have known, that the relief was available before the end of that time period. This "reasonable belief" requirement means that taxpayers will need to pass a subjective test, which may be difficult particularly if the taxpayer has a professional adviser.

Case G also denies relief if the tax liability was calculated in accordance with the 'practice generally prevailing at the time'. This is similar to a restriction in the previous legislation. It can sometimes be difficult to convince HMRC that this test is met. At the other extreme, HMRC cannot argue that an incorrectly inserted figure on a tax return is in accordance with prevailing practice.

### HMRC guidance

The HMRC guidance on overpayment relief is contained in the Self Assessment Claims Manual. It states that the relief not only applies for income tax and CGT purposes, but also to corporation tax and Class 4 NIC (SACM12005). The corresponding relief legislation for companies is in FA 1998, Sch 18, para 51(1).

Overpayment relief claims must be made in the correct form. If a relief claim arises from a mistake in a partnership tax return, all the relevant partners must agree to the

claim, and one partner must be nominated to make it (SACM12045).

### Reasonable belief

With regard to Case C and the "reasonable belief" test (see above), HMRC rather worryingly instructs its officers: "You must judge on a case by case basis whether a person ought reasonably to have known that they had made a mistake and could obtain a repayment or correct an excessive assessment". The guidance adds that HMRC officers "...should consider whether, taking into account their ability and circumstances, the person took reasonable care to ensure they paid the right amount of tax, and had reason to suppose that they might have overpaid." HMRC officers are also reminded that taxpayers are not required to take advice on every aspect of their tax affairs, or to avoid every possible mistake, but that the person is expected to take note of any advice or guidance given by advisers or HMRC (SACM12085).

The 'practice generally prevailing' exception from overpayment relief has the potential to cause difficulties, because it involves HMRC making a judgement call. However, HMRC's guidance on the subject offers some encouragement to taxpayers and their advisers. It states the following (SACM12105):

"In relation to overpayment relief, the onus is on HMRC in any appeal hearing to demonstrate that there was a practice generally prevailing. You may need to refer, among other things, to our published guidance, advice from HMRC technical specialists, reported cases and external comment as evidence of a practice generally prevailing". The Self Assessment Claims Manual also includes some helpful guidance on the form and content of overpayment relief claims.

### 3. NIC on dividends

In *Revenue and Customs v PA Holdings Ltd* [2010] UKUT B8, the Upper-tier tribunal (UTT) dealt with appeals from

both parties against decisions of the First-tier tribunal (FTT).

The case concerned an arrangement by PA Holdings Ltd (PA) to effectively reroute bonuses awarded to UK resident employees, so that they were paid and taxed as dividends rather than employment income. The arrangement broadly involved the payment of funds by PA to an employee benefit trust (EBT) which were subsequently transferred to a newly formed company. Shares in that company were awarded on behalf of PA employees, on which dividends were subsequently paid. The stated purpose of the arrangement was to 'motivate and encourage employees'.

The FTT held that the payments to the employees were employment income. It also held that the payments were distributions, which meant that the payments had to be taxed like dividends, in priority to employment income treatment, as provided by the relevant legislation. For National Insurance purposes, there is no legislation addressing payments of a dual nature (i.e. employment income and dividends), and the FTT therefore held that the payments attracted liability for Class 1 contributions applicable to earnings.

The UTT upheld the decisions of the FTT, and dismissed the appeals. On the National Insurance issue, it was held that the conclusion of the FTT was 'clearly correct'. This would appear to rule out the possibility of a further appeal on this point, in which case we are stuck with the principle that dividends can potentially be liable to employees and employers NIC.

Of course, the dividends in the PA Holdings case were part of the relatively complex arrangement to reward employees. It remains to be seen whether HMRC will use the decision to challenge more straightforward remuneration planning, e.g. including low salary and high dividends. It is possible that HMRC will adopt a similar policy as for employment related securities purposes in respect of 'post-acquisition benefits' from

shares. In other words, dividends paid in respect of 'plain vanilla' ordinary shares would not be challenged. On the other hand, dividends in respect of 'alphabet shares' (e.g. 'a' 'b' 'c' class shares) awarded to employees may be at risk, particularly if those individuals are not already receiving remuneration at a commercial rate.

### The Ramsay Principle

An interesting postscript to the PA Holdings case is that the UTT considered the application of the 'Ramsay' anti-avoidance approach in determining whether the dividend payments fell to be treated as employment income.

The transcript of the PA Holdings case helpfully includes a summary of principles based on anti-avoidance case law subsequent to the Ramsay decision. This provides a useful update on the development of the Ramsay principle following that case law. A transcript of the UTT decision in the PA Holdings case is available from the British and Irish Legal Information Institute (BAILII) website: (<http://www.bailii.org/uk/cases/UKUT/FT/2010/251.html>).

### Cause for Concern?

As indicated above, the circumstances in the PA Holdings case which resulted in a Class 1 NIC change on dividends were quite unusual. It seems unlikely that HMRC would seek Class 1 NIC in cases involving more conventional remuneration planning.

However, if HMRC does adopt an aggressive line, they could perhaps be referred to their own guidance in the National Insurance Manual (at NIM2115):

"Dividends are derived from a shareholding and not employment. They cannot therefore be classed as earnings and do not attract NICs".

Following comments made by the Court of Appeal in the recent *Gaines-Cooper* case that HMRC should be bound by its own guidance, the above HMRC statement in

NIM2115 may prove to be helpful in any argument against a suggested Class 1 NIC charge on dividends. This is provided, of course, that the dividends are lawfully voted and paid.

## 4. Business clearances

It is perhaps a reflection of the complexity of tax legislation and the uncertainty often caused by its ambiguity that HMRC offers various clearance facilities for 'customers' and their advisers:

- Statutory clearances, which the tax legislation requires HMRC to provide (e.g. for transactions in securities, under ITA 2007, s 701);
- A non-statutory clearance service for businesses;
- A non-statutory clearance service for non-business customers, under COP10 ('Information and advice') (<http://www.hmrc.gov.uk/pdfs/cop10.htm>);
- A non-statutory inheritance tax clearance service for business owners, in respect of business property relief (<http://www.hmrc.gov.uk/cap/clearanceiht.htm>); and
- VAT rulings for non-business customers under Notice 700/6, which can be downloaded from HMRC's website ([www.hmrc.gov.uk](http://www.hmrc.gov.uk)).

Statutory clearances are relatively common, but are restricted in their scope (for a list of these clearances, see: <http://www.hmrc.gov.uk/cap/statutory-clearances.pdf>). However, non-statutory business clearances are seemingly less well known, and therefore appear to be used relatively infrequently. This may be because the service is still fairly new. It was piloted by HMRC in January 2008, before being introduced permanently from 1 April 2008. There is fairly detailed guidance on the non-statutory business clearance facility at HMRC's website (<http://www.hmrc.gov.uk/cap/links-dec07.htm>).

## HMRC manual

An entire HMRC manual (the 'Non-Statutory Business Clearance Guidance' (NBCG)) is devoted to the facility. Whilst much of HMRC's internal manual replicates external guidance on the website, it does provide an interesting insight into how HMRC handles non-statutory business clearance applications.

HMRC will provide non-statutory business clearances both pre and post-transaction. 'Businesses' in this context includes property businesses (NBCG2200). The following points are worth noting:

- There must be evidence that the transaction is genuinely contemplated (e.g. by providing a proposed transaction date, supported by any available documentation, such as draft contracts)
- There must be 'demonstrable' material uncertainty about the tax consequences of a transaction affecting the business. HMRC expects that applicants will have reviewed the legislation and any published guidance before making the application.
- HMRC will refuse to accept clearance applications involving tax or National Insurance planning arrangements, and full disclosure is required. Full disclosure includes pointing out if a separate disclosure has been made under the disclosure of tax avoidance schemes (DOTAS) rules covering all or part of transactions.

HMRC provides a useful checklist (<http://www.hmrc.gov.uk/cap/annex-a-checklist.pdf>), which specifies the type of information that should be supplied, although supplementary information and explanations should also be considered, where appropriate. HMRC encourages non-statutory business clearance applications to be submitted by email ([hmrc.southendteam@hmrc.gsi.gov.uk](mailto:hmrc.southendteam@hmrc.gsi.gov.uk)) as this enables the application to be processed more quickly, but also

acknowledges the security risk involved in email communications (NBCG4400).

## Health warning

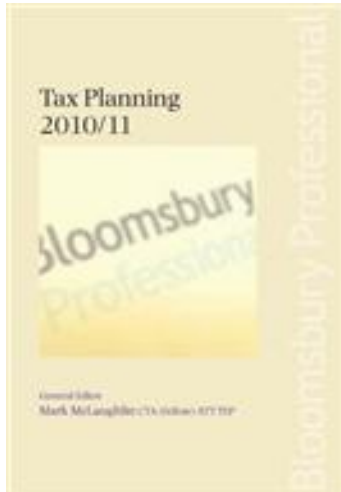
The NBCG manual warns HMRC officers to watch out for "tell-tale signs of tax avoidance" with a view to rejecting the clearance application, if appropriate. However, applications cannot be rejected on the grounds of suspected avoidance without reference to HMRC's Anti-Avoidance Group (NBCG5474). HMRC's NBCG manual also includes sections on 'avoidance indicators', but unfortunately these sections are of no help outside HMRC, as virtually all the text has been withheld under the Freedom of Information Act 2000.

The HMRC guidance rather worryingly indicates that even if a clearance request falls within the strict legislative criteria, it may be inconsistent with the underlying policy behind the legislation. If this inconsistency results in a tax advantage, HMRC will decline to respond (NBCG5640). There is generally no right of appeal against HMRC's view on a clearance, except in limited circumstances (e.g. appealable matters under VATA 1994, s 83(1)). However, if the HMRC caseworker has made a mistake (e.g. by failing to take a material fact into account) it may be possible for the practitioner to apply for the clearance application to be re-examined, or otherwise to contact HMRC's complaints manager (NBCG7100).

## A helpful service?

One of the problems with the non-statutory business clearance service (and clearance applications to HMRC in general) is that if HMRC come up with the 'wrong' answer, you may be stuck with it because as mentioned there is no formal right of appeal. However, my experience of the non-statutory business clearance service has been that it is useful in providing some comfort in cases of doubt, and it is certainly an option to consider in appropriate circumstances.

## Publications for 2010/11



### Tax Planning 2010/11

I am Editor and co-author of 'Tax Planning 2010-11', published by Bloomsbury Professional.

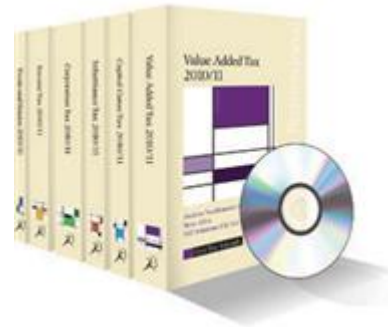
The chapters I have written or co-written deal with incorporation, company purchases of own shares, business property relief, and wills, variations and disclaimers.

Other chapters of the book include 'starting a business' by Rebecca Cave, 'disincorporating a business' by Partha Ray and 'tax planning for the non-resident and non-domiciled' by Robert Maas.

'Tax Planning 2010/11' is updated to include:

- Finance Act 2010, Finance (No. 2) Act 2010;
- Corporation Tax Act 2010;
- Taxation (International and Other Provisions) Act 2010;
- Recent case decisions and new HMRC practices;
- June 2010 budget announcements of relevant proposed future tax changes; and
- Commentary on the new CGT rate and changes to entrepreneurs' relief

For further information and to order a copy of Tax Planning 2010-11, visit: [www.bloomsburyprofessional.com](http://www.bloomsburyprofessional.com)



### Core Tax Annuals 2010/11

I am also the Editor of the Core Tax Annuals 2010/11, published by Bloomsbury Professional. I am co-author of the Inheritance Tax Annual 2010/11, which is part of the series. The titles in the Core Tax Annuals series are:

#### Corporation Tax 2010/11

By Juliana Watterston

#### Capital Gains Tax 2010/11

By Rebecca Cave & Iris Wunschmann-Lyall

#### Income Tax 2010/11

By Sarah Laing

#### Inheritance Tax 2010/11

By Mark McLaughlin, Toby Harris & Iris Wunschmann-Lyall

#### Trusts and Estates 2010/11

By Iris Wunschmann-Lyall and Christine Erwood

#### Value Added Tax 2010/11

By Andrew Needham

The books represent excellent value at £150 plus VAT for the whole set.

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