PRACTICE UPDATE

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1. Penalties for Director's loans?

The new penalty regime for incorrect tax returns affects income tax, corporation tax, VAT, PAYE and other returns, for periods from 1 April 2008 which are due to be filed after 31 March 2009, and is therefore now generally upon us in terms of personal and company tax returns for current periods.

A recent article in the ICAEW's *Taxline* highlighted examples in HMRC's *Compliance Handbook* of 'deliberate but not concealed' inaccuracies, which could attract penalties in the range 20% to 70%. Paragraph CH81150 gives the following example:

"deliberately withdrawing money for personal use from an incorporated business and not making any attempt to make sure it is treated correctly for tax purposes."

In practice, the owners of many small, owner-managed companies often withdraw funds during the accounting period, resulting in an overdrawn director's loan account. This overdrawn balance is then normally cleared by bonus or dividend, perhaps before the end of the accounting period, or within the following 9 months.

Is that so…?

There is a statutory requirement for employers to apply PAYE to relevant payments made to an employee during a tax year. However, notwithstanding any company law issues, there seems to be nothing in the tax statute that treats any withdrawal of funds by a company shareholder as a culpable offence.

If a company owner regularly withdraws funds resulting in an overdrawn director's loan account, which is cleared by a bonus every year, it is not difficult to envisage HMRC arguing that an offence has been committed (if, for example, this results in a late PAYE return), with a view to imposing a penalty. However, if the loan account is regularly cleared by dividends, it is difficult to see how HMRC could impose a penalty in such circumstances.

Avoiding the issue

Of course, in practice it may be difficult to prove that funds have been withdrawn from the company in the capacity of a shareholder, rather than as a director or employee. If a business owner receives a combination of salary (or bonus) and dividends, it may be advisable to keep separate loan accounts for the same of individual, to demonstrate the capacity in which each withdrawal has been made.

In view of HMRC's comments in CH81150 (even if they are brief and not altogether clear), it would be prudent to avoid overdrawn loan accounts if at all possible, particularly where it appears that funds have been withdrawn on account of a salary or bonus. It will be interesting to see the extent to which HMRC apply the guidance in its compliance handbook. In the meantime, clients should be made

aware of HMRC's view on penalties in respect of company withdrawals.

2. What's it all about?

Taxpayers (or their advisers) completing 2007/08 tax returns have been faced with answering the following question, which has not been asked in tax returns for previous years:

"Total amount of any income included anywhere on this Tax Return, derived from the provision of your services through a service company – read page TRG 15 of the guide".

Space prevents me from quoting the guidance in full (so see http://www.hmrc.gov.uk/worksheets/sa150.pdf), but it states:

"You should complete this box if you have received any form of income (including employment income and dividends) during the year in question from a company through which you provided your services personally and of which you are a sole or joint shareholder."

Cause for concern

HMRC have indicated that the purpose of the question is to improve risk assessment of companies within the IR35 or Managed Service Company (MSC) rules. HMRC also stressed that the question is not related to gathering information about owner managed companies more generally.

Whilst HMRC's statements provided some reassurance that taxpayer responses to the service company question were not to be used for some other purpose (e.g. for the purposes of future 'income shifting' legislation), I contacted HMRC and asked:

- If the service company question is aimed at potential IR35 companies or MSCs, why is the question drafted so widely?; and
- If the responses to the question are not to be used other than to find IR35 companies and MSCs, would HMRC publicly confirm that the data would not be used for any other purpose, to reassure service company owners who are not IR35 companies or MSCs.

HMRC responded to the first question by saying that they decided on a simple form of words for the question, rather than to attempt to define their target group, which may have resulted in a lengthy, complex question.

HMRC would not give any assurances on the second question, stating that to permanently restrict risk analysis would be impracticable, and would fetter HMRC's ability to identify and address wider risk.

The latter statement will be a concern to many owner-managed companies and their advisers. HMRC do not appear to rule out the possibility that the responses to the service company question will be used for purposes other than identifying IR35 companies and MSCs.

Whilst the 'income shifting' proposals have been shelved for the time being, one wonders whether the data could be used for that purpose in the future. Alternatively, could the information be used to identify owner-managed companies paying dividends instead of what HMRC consider to be a commercial salary? It is not inconceivable that legislation may one day be introduced to prevent or discourage remuneration planning in owner-managed businesses, which often involves low salaries and high dividends. The service company question on tax returns would of some assistance to HMRC if that was the case.

Is it lawful?

The main professional bodies have made representations to HMRC about the service company question. One of the concerns raised was whether HMRC are entitled to include it on tax returns in the first place. HMRC maintain that they are, on the basis that TMA 1970, s 8 requires a return to be made and delivered "…for the purposes of establishing the amounts

in which a person is chargeable to income tax and capital gains tax". However, is the service company actually required for this purpose? The taxpayer will already be returning details of income from the company on the return, without the need for the service company question.

What concerns me most is that (as far as I am aware) HMRC did not consult with the professional bodies beforehand about the inclusion of the question on the tax return form. Why is this? Could it be that the simply decided to go ahead and do it, based on the old adage of it being easier to "seek forgiveness than ask permission"?

Nevertheless, we appear to be stuck with this question on the tax return. One can merely hope that HMRC will be true to their word, and only use the data gathered for the purposes of tracking down IR35 companies and MSCs.

3. 'Settlements' & dividends

The Government may have shelved its proposed 'income shifting' legislation for now, but it seems that the 'settlements' anti-avoidance provisions are still alive and kicking even after the House of Lords decision in *Arctic Systems*, with two cases recently being heard before the Special Commissioners.

Dividend waivers

In *Buck v Revenue and Customs Commissioners* [2008] SpC 716, Mr Buck owned 9,999 shares in the company out of 10,000. His wife owned the other share. Mr Buck waived dividend entitlements in respect of his 9,999 shares, which enabled enhanced dividends to be paid on his wife's share. HMRC argued that the dividend waivers constituted a 'settlement', and assessed Mr Buck on the enhanced dividends. The taxpayer appealed, but was not represented at the hearing. The Special Commissioner dismissed the taxpayer's appeal.

Looking at the facts, it is perhaps unsurprising that HMRC took this case and won. The company's profits and reserves were modest for the two years in question. Mrs Buck received gross dividends of £39,371 and £27,774 in those years. If the company were to pay dividends at the same rate in respect of all its shares, it would have needed reserves of around £300 million!

When paying dividends following a waiver in similar circumstances, it is therefore important to ensure that there are sufficient distributable reserves to cover a dividend in respect of shares subject to the waiver.

There is a potential exception from the settlements provisions in respect of outright gifts between spouses or civil partners (ITTOIA 2005, s 626). However, this exception does not apply to gifts which only carry a right to income. The Special Commissioner held that there was no outright gift in this case, but a waiver of dividends. Mr Buck had retained the shares, rather than gifting them. Thus in contrast to the *Arctic Systems* case, the 'outright gifts' exception did not apply.

Dividends to minor children

In *Mr & Mrs Bird v Revenue and Customs Commissioners* [2008], Mr and Mrs Bird were the initial shareholders of their kitchen furniture company, owning one share each. The company issued a further 98 shares at par, 19 shares each to Mr and Mrs Bird, and 20 shares to each of their three daughters. Dividends were paid to all the shareholders. HMRC argued that the dividends paid to the daughters (until they reached age 18) constituted income arising under a 'settlement', which should be treated as Mr and Mrs Bird's income. The taxpayers appealed.

The Special Commissioner considered previous case law regarding the settlements anti-avoidance provisions, in which a corporate structure was used to provide income to a minor child. One of the cases (*Butler v Wildin*) was

considered to be comparable to the situation in which Mr and Mrs Bird had made an 'arrangement' in the Commissioner's view for their minor daughters to acquire a 60% equity stake in the company.

On the question of whether there had been an element of 'bounty' in the arrangement (such that the arrangement could constitute a 'settlement'), Mr and Mrs Bird (who were unrepresented) had contended that the daughters' share acquisition was part of a commercial arrangement, as a 'quid pro quo' for loans made to the company out of funds inherited by the daughters. However, the Special Commissioner held that this argument was not sustainable in the particular circumstances. The taxpayers' appeal was dismissed in respect of the settlements provisions.

Fraudulent or negligent?

However, a further interesting point in this case was whether HMRC were entitled to make Extended Time Limit (ETL) assessments for tax years in which income had arisen outside the normal time limits. This was only possible if Mr and Mrs Bird had acted negligently in failing to include the minor daughters' dividends on their own tax returns. The Special Commissioner asked what a 'reasonable taxpayer' would have entered on his or her tax return, and reviewed the information HMRC made available to assist taxpayers in completing their returns in respect of trust and settlement income. The Commissioner concluded that there had been no 'negligent conduct' on Mr and Mrs Bird's part, and therefore the ETL assessments could not be made.

Clearly, the 'settlements' provisions still need to be considered carefully in the context of family businesses, even after the *Arctic Systems* decision.

4. No more Commissioners!

MANY ACCOUNTANTS will have experience of attending hearings at the local General Commissioners. However, all that is about to change. The new Tax Tribunals system is due to commence from 1 April 2009. This signals the end of the existing General and Special Commissioners, and also the VAT and Duties and Section 706 Tribunals. The Tax Tribunals will hear both direct and indirect tax appeals. Most appeals will initially be dealt with by a 'First Tier' Tribunal, via a network of 130 hearing centres across the country. An 'Upper Tribunal' will hear appeals on points of law from the First Tier Tribunal.

Internal reviews

HMRC are also implementing a system of 'internal reviews' to coincide with the new Tax Tribunals. Internal reviews are broadly intended to provide an alternative form of dispute resolution between taxpayers and HMRC, instead of appeals proceeding directly to the Tax Tribunal. As the name implies, internal reviews will be conducted from within HMRC. Whilst internal reviews could save the time and cost of a Tax Tribunal hearing, some concern has already been expressed by practitioners in discussions with HMRC that internal reviews may not be impartial.

Which track?

Cases will be allocated between procedural 'tracks' depending on the nature of the appeal, and on its relative complexity. If you are considering taking an appeal or simply wish to know more about the new system, please contact me.

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