PRACTICE UPDATE

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1. Loans and capital losses

Tax relief for losses has obviously become a much more important issue for taxpayers since the recession started. However, as in many other areas of tax, securing loss relief is not always as straightforward as it should be. Fortunately, a recent tax case offers some assistance in some cases.

Capital Gains Tax (CGT) loss relief is available for loans to traders, if certain conditions are satisfied (TCGA 1992, s 253). A capital loss may also be available to claim when an asset has become of negligible value (s 24). If the asset in question is shares, that capital loss can often be turned into an income tax loss and offset against taxable income upon the making of a claim, again if the relevant conditions are satisfied (ITA 2007, s 132).

Conversion to shares

However, if a cash debt is converted into shares, the value of the shares is potentially restricted to the market value of the debt at the time of conversion (s 251(3)). So if, for example, the debt is irrecoverable because the company is insolvent, the value of the shares is likely to be negligible when the debt is converted into shares. This means that a negligible value claim may not be possible in respect of the shares.

In *Fletcher v HMRC* [2008] SpC 711, a loan to a company was capitalised by the issue of 'B' ordinary shares, with rights that were arguably worthless. The company did not succeed, and a negligible value claim was subsequently made. The point at issue was the base cost of those shares. HMRC argued that there was no loss in respect of the 'B' shares, on the basis that they had no value when the loan was capitalised, by virtue of s 251(3).

Share issue was a 'reorganisation'

The Special Commissioner allowed the taxpayer's appeal. If a loan is converted into shares, and the shares were issued as part of a reorganisation of the company's share capital (within TCGA 1992, s 126), the transaction would not be treated as an acquisition, so that s 251(3) could not apply. The Commissioner also held that an increase in share capital could be a reorganisation even if it did not come within the precise wording of s 126(2), provided that the existing shareholders acquired the new shares because they were existing shareholders and in proportion to their existing beneficial holdings.

The potential effect of a debt conversion into shares being treated as a reorganisation for CGT purposes is that there is no disposal of the original shares and no acquisition of the additional shares. All the shares are treated as a single shareholding. The base cost of those shares is generally the consideration paid originally and also

under the rights issue, provided that the capitalisation is an arm's length bargain (s 128(2)). It represents a timely tax planning opportunity in the current economic climate.

2. The goodwill trap

Business sales and incorporations may be on the decline in the present economic climate, but goodwill valuation is very much a 'live' issue.

HMRCs guidance on goodwill changed in September 2008. Previously (following case law) HMRC likened the behaviour of business customers to certain types of animal (i.e. dogs, cats, rabbits and rats). Developing this principle, in HMRC's view there existed three components to goodwill (i.e. personal, inherent and free). However, a Practice Note was issued on 30 January 2009 ('Apportioning the Price Paid for a Business as a Going Concern'), explaining that HMRC and the Valuation Office Agency (VOA) consider that the price paid for a business as a going concern should be apportioned between goodwill and other assets included in the sale, and describing how this should be done. Referring to the various goodwill components, HMRC state "These subdivisions are no longer considered helpful as they tend to cause confusion".

Incorporations

In the context of business incorporations, HMRC state the following (CG 68050):

"If on the incorporation of a business the transferor has control of the company, the disposal of goodwill will be a transfer between connected persons within TCGA92/S286(6). Where the transfer is between connected persons, any goodwill transferred to the company will be deemed to have been disposed of for a consideration equal to its market value in accordance with TCGA92/S17 and TCGA92/S18."

"If you are dealing with a transfer of goodwill between connected persons it is essential that you should establish by reference to the facts whether the transferee has, in fact, succeeded to the business as a going concern (as opposed to having acquired one or more of the business assets) before sending a request to SAV for a valuation of goodwill. You should not accept that there has been a disposal of goodwill unless there is factual evidence of a transfer of the business as a going concern."

HMRC consider that because goodwill is inseparable from the business from which it is derived, the disposal of a business as a going concern must involve the transfer of goodwill.

Valuation issues

Where businesses are carried on from 'trade related property' (e.g. public houses, hotels, petrol stations, cinemas, restaurants, care homes etc), HMRC appear to accept that there will be an element of goodwill in such businesses when sold as a going concern. However, they consider that the sale price will reflect the value of tangible assets and other assets such as goodwill, and that it is necessary to consider the contribution that each asset makes to the combined value. The broad message of the Practice Note seems to be that goodwill valuations of businesses carried on from trade related premises will generally be lower than for other types of businesses.

Caution

Of course, the Practice Note is only a statement of HMRC's views regarding goodwill, and does not carry the force of law. The approach described in the Practice Note was rejected by the Royal Institute of Chartered Surveyors, and further discussion between HMRC, VOA and interested professional bodies seems likely. In the meantime, the valuation of goodwill in trade related properties should be treated with caution, and specialist valuation advice should be considered.

If any goodwill is attributable to the personal skills of the proprietor (e.g. a chef or hairdresser), in HMRC's view such personal goodwill is not transferable on a

sale of the business (CG 68010). This view has not changed, but unfortunately this presents a trap for the unwary. HMRC guidance on goodwill and trade related properties and the above Practice Note can be found on HMRC's website: http://www.hmrc.gov.uk/svd/goodwill-overview.htm

3. Termination payments

An unfortunate consequence of the economic climate is that more people will find themselves out of work. At least there is an income tax exemption for statutory redundancy payments (ITEPA 2003, s 309). Non-statutory redundancy payments are charged to tax under ITEPA 2003, s 401, subject to various potential exceptions including the first £30,000 under s 403, and no Class 1 NIC.

HMRC generally tend to look closely at claims for the £30,000 exemption following the termination of an employment. The Employment Income Manual states (at EIM 13750): "It is vital to identify redundancy payments properly because…what people call redundancy payments may not fall within the special definition of redundancy…" (nb 'special' means the definition or redundancy in the Employment Rights Act 1996, s 139). It is therefore necessary to consider if HMRC could actually treat the payment differently for tax purposes, e.g. as employment income (except for statutory redundancy payments), or possibly as an employer-financed retirement benefits scheme (ITEPA 2003, s 394).

Employment earnings or damages?

For termination payments other than for redundancy, in terms of claiming exemption for the first £30,000 of such payments, the general approach for employers should be to terminate the employment first, and agree a financial settlement later. A key question is whether a payment is made under the employment contract (i.e. earnings) or is damages for breach of contract.

If the employee has the contractual right to receive pay in lieu of notice (a PILON), case law has established that this also constitute earnings, even if it is paid on termination of employment. This would appear to be the case even if the PILON is payable at the employer's reserved right or discretion (EMI v Coldicott [1999] STC 803 CA and Richardson v Delaney [2001] STC 1328). In the latter case, the employee had accepted a lump sum of £75,000 following negotiations with the employer, which was held to constitute earnings.

By contrast, a termination payment following a breach of contract was held to be damages even though the employer had the right to make a PILON which was not exercised in Cerberus Software v Rowley (CA, [2001] EWCA Civ 78). In that employment law case, a contractual clause stated that the employer 'may' make a PILON. The Court held this to mean that the employer was free to give neither notice nor a PILON but instead to breach the contract. The payment was therefore damages, which qualified for the £30,000 exemption, and was not earnings so that no NIC liability arose.

Clarifying the position

If an employer terminates in breach of the employment contract, such as by dismissing the employee without notice, and does not make a PILON in respect of that notice period, a payment subsequently made to the employee is generally more in the nature of damages than employment earnings. It therefore follows that the chances of a compensation payment constituting damages may be enhanced broadly if:

- The employer breaches the employment contract by breaching the notice period and failing to make a PILON;
- The employer does not make any payment for breach of contract until after the employment has terminated;
- Correspondence and documentation between the employer and the employee indicates that the employee's claim is for damages for breach of contract.

Two final points are worth mentioning. First, be aware of HMRC's approach to termination and damages claims. This is contained in Revenue Interpretation 249 and in the Employment Income Manual at EIM12800 and following. Second, be aware of the legal issues involved when termination an employment, and seek advice from an employment law specialist if necessary.

4. Furnished Holiday Lettings

The Budget in April included some good news and bad news for owners of furnished holiday lettings (FHLs).

Property letting is not a trade for tax purposes, but owners of FHLs that meet certain conditions can enjoy a number of potential tax benefits associated with trading activities, including:

- entrepreneurs' relief;
- rollover and holdover relief;
- IHT business property relief;
- capital allowances; and
- loss relief (against general income);

The good news is that landlords with FHLs elsewhere in the European Economic Area (EEA) can now benefit from FHL tax treatment in respect of them, if the qualifying conditions for FHL treatment are satisfied. Previously, they were treated in the same way as any other type of overseas property.

Going, going…

The bad news is that the FHL rules are being repealed from next April, for both UK and EEA properties.

In the meantime, there is a window of opportunity to take advantage of the FHL rules. For example, HMRC will accept claims for relief or requests for FHL treatment on EEA properties within the normal time limits for amending self assessment return.

However, certain claims such as rollover relief and holdover relief are subject to a longer claim period (i.e. 5 years from 31 January following the tax year in question for individuals, or within 6 years from the end of the accounting period for companies). In addition, HMRC will accept such claims as CGT taper relief, relief for pension contributions and substantial shareholdings exemption within this longer timeframe.

Furthermore, HMRC will accept late amendments to self assessment returns for 2007 (individuals) and corporation tax returns for accounting periods ending after 31 December 2006, in respect of FHLs elsewhere within the EEA.

Grab those reliefs!

No capital allowances are available for expenditure incurred on plant and machinery used in a dwelling house. However, under the FHL rules, capital allowances may be claimed on such expenditure. Claims for plant and machinery expenditure in respect of EEA FHL dwelling houses are also possible for earlier periods, within certain limits. However, claims for the 10% wear and tear allowance will not be available.

The proposed repeal of FHL tax treatment means that FHL owners who wish to claim entrepreneurs' relief will need to sell their FHL businesses by 5 April 2010. Further details on FHL claims in respect of EEA properties are available in a technical note available via the HMRC website: http://www.hmrc.gov.uk/budget2009/furnished-hol-lets-1015.htm.

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