Tax Advice for the Expanding Family Business – webinar notes

1. Introduction

1.1 Objectives and Content

The webinar will focus on:

- Owner managed business over an expected life cycle (commencement, expansion, sale or succession)
- Tax implications and benefits of the business vehicle options (sole trader, partnership, LLP, company)
- Structures that can be used to minimise tax and the risks associated with such planning.
- Tax decision trees including whether to expand to the VAT registration threshold

1.2 Legislative Background

This webinar has been written using the tax law in force as at 31 August 2013. Tax law should be certain but especially in recent years there is less certainty because of the publicity and attitude to tax avoidance. Tax avoidance is legal but if HMRC believe that an avoidance scheme is overly aggressive a new power was enacted in Finance Act 2013 to enable them to challenge egregious and aggressive avoidance which attempts to exploit a loophole in the law which was unintended. The General Anti Abuse Rule (GAAR) contains a double reasonableness test and arrangements which are reasonable and have been entered into for legitimate commercial purposes should not be at risk of challenge from HMRC.

In theory and theoretical principle there should be horizontal equity between taxpayers. This means that taxpayers in similar circumstances should pay similar amounts of tax. In practice, choosing the right vehicle with which to conduct a business can produce dramatically different results. However, such a choice is commercial and sensible. That choice should not be driven by tax considerations alone. Tax legislation can and does change with alarming frequency. Incorporating a business might be relatively simple but like eggs it could be difficult to unscramble.

Tax law can also change with a ministerial announcement such as occurred on 25 October when draft clauses were published which will be included in Finance Bill 2014 but which have effect on or after 25 October 2013. These clauses followed a very short consultation when HMRC announced its intention to stop what it perceived was an unacceptable avoidance device. The main changes were necessary after HM Revenue & Customs (HMRC) became aware of two main arrangements. They involve:

- Service companies that are under-remunerated by partnerships for the services that they provide.
- Interest receipts that arise to individuals from debt in highly leveraged companies and/or which has excessive rates of interest

1.3 Disclaimer

This briefing paper which accompanies the webinar can only provide a short overview and it is essential to seek professional advice before applying any of the contents of this article or suggestions within the article. Whilst every care has been taken to ensure the accuracy of the content of this work, no responsibility for loss occasioned to any person acting or refraining from action as a result of the material in this publication can be accepted by the author, editors, publishers or AAT

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Details and calculations are correct at time of writing which is 31 August 2013

2. Structure

2.1 The options

One of the first decisions that any person considering starting a business needs to take is what structure the business should take. Essentially the choice comes down to two options and these are:

- Sole trader/partnership (including LLP)
- Limited company

The business goals will play a large factor in determining the best business structure to choose. That word 'goals' should also include an exit strategy. Some clients may start in business and be perfectly happy just to make a living wage. They will not aspire to make a fortune or expand the business and are content to maintain a business.

A sole trade/partnership structure is the simplest form of structure and is often the most appropriate for start-up businesses. However it is important to remember that these structures do not offer limited liability, meaning that the owner's personal assets may be at risk.

As a general rule, the rate of tax that a company will pay is less than that which an individual would pay. But the individual needs income to live and will require to extract the profit by way of salary, loan, dividend or possibly as capital which will usually involve sale or liquidation.

In broad principle, there are 4 effective ways to extract profits from companies which are:

1. salary

2. dividends

3. directors loan

4. sale of company

Looking at Directors' loan accounts, the cash is taken and then the loan cleared by dividend or salary. Straddling two tax years means that 2 years personal allowances can be effectively utilised and any S455 CTA 2009 can effectively be swerved.

Different levels of profitability create a different financial picture and any decision regarding structure requires careful consideration of the current and future objectives.

2.2 Comparison of tax and NIC costs using different profit levels

Many companies also enjoy substantial flexibility to structure an efficient reward package which takes advantage of the exemptions and incentives that have been enacted for employee taxation. Profits can therefore be extracted through a mix of salary, bonuses, pensions, dividends and other benefits to create a tax efficient package.

In 2011/12, the latest year for which statistics are available from the ONS, average earnings are £26,500

It should be remembered that there are costs associated with operating through a limited company and the cost of compliance may be substantially increased if electronic filing of returns which is mandatory is to be achieved. It is also possible to create an arrangement which has more than one component. A sole trader could set up a parallel service company that would provide management services and is trading.

This might be obviously advantageous if, for example, earnings were potentially above the top rate threshold (£150,000).

2.3 Tax costs Comparisons

The structure within which a business should be conducted should not be driven by tax alone but tax may be an influence. Tax law keeps changing and a decision which made good sense from a tax perspective can cease to be sensible if the law changes. For example, in 2004 there was a zero rate of corporation tax on the first £10,000 and so for many small businesses it made sense to incorporate.

The tables below shows the 'take home amount' after tax and NIC comparing self-employment, employment and operating through a company after extracting the profits by dividend. Inevitably, a combination of these options might provide the best solution and in some cases the best solution may depend on the circumstances of the individual owner of the business. At present and in the recent past years the main difference arises from NIC and so extracting profits by way of dividend appears to be an efficient method. But the future will change things yet again.

From 6 April 2014, the employment allowance for NIC will enable many small businesses to reduce their employers' secondary NIC bill by up to £2000. The Employment Allowance will be straightforward to claim using standard payroll software. You can read more on this at:

- **HMRC News**
- **The National Insurance Contributions Bill**

The measure is expected to have a positive impact on businesses and civil society organisations by reducing their employer NICs bill. Up to 1.25 million employers will benefit, with over 90 per cent of the benefit going to small businesses with fewer than 250 employees. As a result 450,000 small employers will no longer pay Class 1 secondary NICs in 2014-15 and, on average, employers with fewer than ten employees over the course of the year will see their employer NICs bill reduced by 80 per cent. This could make it more attractive to operate through a company and extract more of the profit by way of salary.

I am indebted to Rebecca Benneyworth who produced an article looking at the potential tax benefits of operating as a company compared to a sole trader The principle behind **Table 1** is to identify for a client the maximum possible tax saving achievable without involving any other parties in the business, but allowing for all of the profits earned to be available to spend.

Consideration of other tax and non-tax issues is then carried out separately to overlay these basic figures. Tables 2 and 4 below enable an updated comparison to be made for 2013/14. The saving for profits of £50,000 has reduced to £2939 but that might be a sufficient incentive to incorporate.

What must also be kept in mind is that the more complex and sophisticated the structure or structures, the higher the HMRC expectation of reasonable care will be. Tax can be complex and such complexity increases the risk of mistakes occurring. Any taxpayer entering the murky waters of tax planning and avoidance must take great care to get it right. Mistakes will face the challenge of a penalty arising under Schedule 24 FA 2007 on the basis that it was a failure to take reasonable care. If HMRC challenge a return and identify that tax has been underpaid, the maximum mitigation of that penalty after telling , helping and giving access to documents and information will be 15%. If the enquiry has suffered delay and HMRC have found if necessary to threaten or use their information powers in Schedule 36 FA 2008, the penalty for a failure to take reasonable care could be as high as 30%..

TABLE 1 – POTENTIAL TAX SAVINGS ON INCORPORATION 2011/12

Profit	Sole trader	Company	Saving
£10,000	£885	£586	£299
£15,000	£2,335	£1,586	£749
£20,000	£3,785	£2,586	£1,199
£30,000	£6,685	£4,586	£2,099
£40,000	£9,585	£6,586	£2,999
£50,000	£13,463	£9,206	£4,257
£75,000	£23,963	£19,206	£4,757

The difficult economic situation currently has meant that there is little increase in average earnings but with the higher personal allowances (currently £9440) and much narrower basic rate band more people are paying the 40% tax rate.

Many people are content to pay basic rate tax but will seek advice on ways to avoid paying the higher rate. An obvious way is to use a parallel service company which provides the business with management services and to use this trading company as a money box, accumulating the retained profits. The need to have an exit strategy early on in the business will quickly become apparent.

The strategy may be to liquidate this company in due course to obtain entrepreneur's relief and an effective rate of CGT of 10%. Another alternative would be to sell the business and then extract the retained profits over a period of years by way of dividend and so long as the shareholder recipients remain basic rate taxpayers there is no further tax to pay on this under the resent tax rules.

Table 2: Self-employed for 2013/14

Amount	Class 2 NIC	Class 4 NIC	Tax	Take home amount
26500	140	1687	3412	21261
50000	140	3203	9822	36835
100000	140	4203	29822	65835
150000	140	5203	50616	94041
300000	140	8203	118116	173541

Table 3: Employment for 2013/14

Amount	ER 2 NIC	EE NIC	Tax	Take Home Amount
26500	2595	1938	2893	19074
50000	5838	5069	7487	31606
100000	12738	4960	24727	57575
150000	19638	6214	45743	78405
300000	40338	9214	86811	163637

Table 4 : Limited Liability for 2013/14

Amount	CT	Dividend	Tax	Take Home Amount
26500	5300	21200	0	21200
50000	10,000	40,000	676	39324
100000	20,000	80,000	10673	69327
150000	30,000	120,000	20673	99327
300000	60,000	37305	0	37305 + 202595

The above tables are overly simplistic but they do reaffirm the perceived wisdom that with the additional compliance costs and burdens associated with incorporation, a limited company vehicle will start to produce significant tax savings if profits exceed £40,000 and the profits are extracted by way of dividend.

2.4 Variations to minimize tax costs

There can be little doubt that extracting business profits by way of salary is obviously the most costly in tax terms but again the analysis is overly simplistic because of the many exemptions to be found within ITEPA for employees. The most common of these will be contributions into a pension scheme.

A husband and wife trading using a limited company could arrange a significant package of benefits which might include:

- Contributions into a pension scheme
- Use of a very low emission company car with very low scale benefit
- Christmas party £150 each
- Training costs (Spanish lessons, martial arts and CPD)
- Professional subscriptions
- Free parking near place of work
- Incidental use of pool car (or van or double cab pick-up truck)
- Bicycles
- Phone (1 each)
- Eye tests and corrective glasses for computer users
- Beneficial loans??
- Childcare vouchers and nursery care

All of the above could make a substantial difference to the quality of lifestyle enjoyed by the business proprietors.

Again, the table would suggest that there is a significant benefit in terms of the tax cost when comparing being self-employed with that of operating through a company and extracting profits by way of dividend. But, for example, the equations reverse if there is 90% business usage of a large high emission vehicle and that vehicle was held to be provided by the company. In such a case the taxable benefit deemed to arise on the employee or shareholder may well make incorporation costly.

2.4 Important to plan things correctly

Table of new tax penalties which apply to returns filed after 1 April 2009

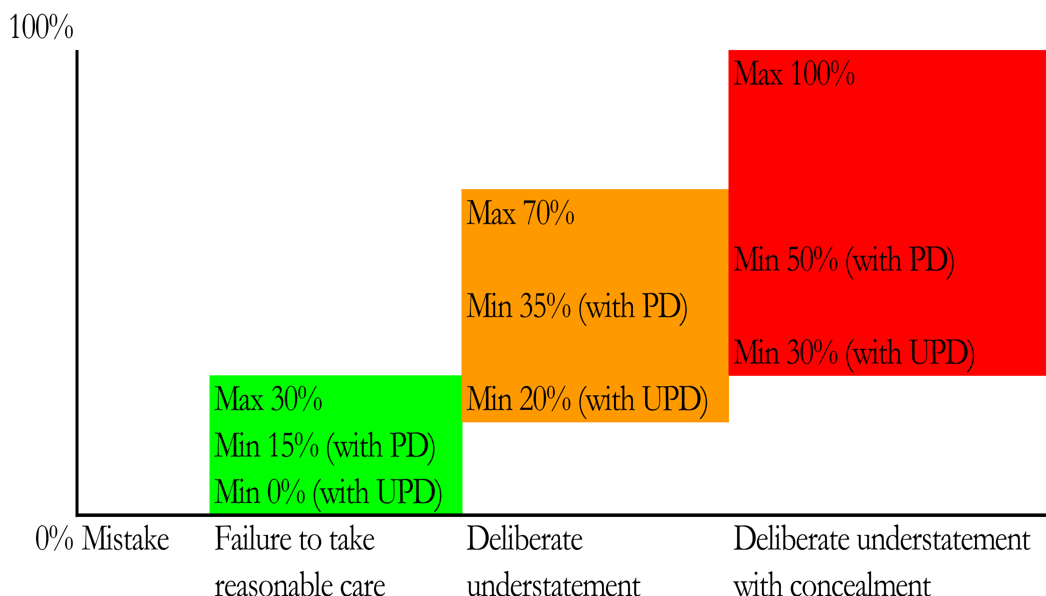
	Prompted disclosure	Mistake despite reasonable care	Failure to take reasonable care	Deliberate understatement	Deliberate understatement with concealment
1.	Max	0%	30%	70%	100%
2.	Min: Prompted	0%	15%	35%	50%
3.	Max reduction for prompted (1. – 2.)	0%	15%	35%	50%

	Unprompted disclosure	Mistake despite reasonable care	Failure to take reasonable care	Deliberate understatement	Deliberate understatement with concealment
4.	Max	0%	30%	70%	100%
5.	Min: Prompted	0%	0%	20%	30%
6.	Max reduction for prompted (4. – 5.)	0%	30%	50%	70%

The maximum reduction in penalties, from the starting point of the maximum (1. above), depends on whether the person made disclosure after prompting (3.) or not (6.). To summarise the position, if an error is discovered it makes sense to disclose it fully, helping HMRC by revealing the nature of the error, the quantity and getting it sorted as quickly as possible.

The New Penalty Regime – what the stepped approach looks like

UPD = Unprompted voluntary disclosure; PD = Prompted (after HMRC challenge) disclosure



2.5 Tax traps for the unwary

The UK tax legislation has many traps for the unwary or poorly advised and the car benefit legislation is especially difficult because it can create a fiscal fiction and unintended punitive tax results. It deems a car made available to an employee to be a taxable benefit. Below, I have summarized several cases which demonstrate that HMRC will apply the law strictly even though the result is blatantly unfair and punitive.

If a tax mitigation exercise was planned using a parallel service company and there are business cars, care needs to be taken not to make a mistake and have a benefit deemed to apply to one of the shareholders.

2.5.1 Whitby and Another v HMRC 2009, UK FTT 311

Point at Issue:
Whether cars leased by employees from an employer were assessable to car and fuel benefits even though the employees leased the car paying an arm's length rental for its use.

Facts:
Mr Whitby and Mr Ball were chosen as a test case. Previously they had enjoyed the use of a company car but, in common with a number of other employees of their employer, they entered into car leasing contracts with the employer.

Following a PAYE audit visit in April 2006, HMRC formed the view that there were income tax and national insurance implications of the car arrangement.

The total benefits being assessed on Mr Whitby, for example, were £74,672.

In 2003 new arrangements for cars occurred whereby the holding company bought a dozen cars and then leased them to its subsidiary which employed Mr Whitby and Mr Ball. In turn the employer company leased them to certain employees. The car lease terms were arm's length with the lessor bearing the cost of servicing, insurance and road fund licence but the employee running the car, paying for fuel and insuring it.

When the car was used for business use, the approved mileage rate was used (40p per mile for the first 10,000 miles) rather than the company car mileage rate which is at a much lower rate. The cars were freely available to the employees and family members and the employer only paid mileage allowance for business mileage insisting upon mileage logs being kept to justify claims for mileage reimbursement.

Decision:
It was decided that the vehicles were made available by the employer and so the charge under Section 114 applied. By concession, a deduction for the rental payments made by the employees was allowed under Section 144 but this was by concession rather than strict contractual arrangement that it was a condition of being available for private use that the payment was made.

There was an error, obviously unintended, about what was business and private mileage with the result that some private mileage involving home to work travel had been reimbursed by the employer. The fuel charge is an all or nothing charge with the result that it was triggered even though the private fuel was minimal.

In looking at the approved mileage allowance within Section 229, it was a condition that if the vehicle is a company vehicle this section does not apply. HMRC allowed the advisory fuel rates which currently are about 14p per mile for an over 2000cc vehicle but the excess was fully taxable.

In its decision, the Tribunal expressed some sympathy for the taxpayers but found fully for HMRC.

Tax law contains many traps for the unwary and some of the legislation creates fiscal fictions which can have very expensive tax consequences.

2.5.2 Stanford Management Services Ltd [2010] TC 00409

Two directors leased Mercedes cars. The lease contracts were in the name of the company but in fact all payments were debited to the directors' loan account. The substance of the transaction was that the directors had leased the cars and paid for them and were in reality the registered keepers but the detail of the contract found that the company had signed the contract for leasing the cars from Mercedes and then provided the cars to the directors. A benefit in kind arose even though the company was not bearing any of the costs. The directors were bearing the costs personally out of their own money. A summary of the decision follows:

Stanford Management Services v Commissioners of HMRC (2010) UK FTT 98

Point at Issue:
Whether the provision of cars to the directors of a company by way of a leasing agreement between the company and the lease company supplying the cars created a nominee or agency agreement and was effective in excusing the director from the normal benefit in kind charge and class 1A national insurance for a company car.

Facts:
Before considering the facts of this case which are complex because of misunderstandings of the law and mistakes in the tax treatment, it is worth looking at some of the background legislation to be found in Sections 114 to 118 ITEPA 2003 and Sections 35A, 35B, 36 and 36A of the Companies Act 1985. The Companies Act's provision suggests that a party contracting with a company need not ask whether there are any limitations on the powers of the directors to bind the company.

The directors wished to acquire new Mercedes cars by leasing and believed that it was cheaper to do this through the company. They had been offered a three year lease agreement with Daimler Chrysler Financial Services. The list price of each car was £70,000. The cost of each car was charged to the directors' loan account and the directors believed the company was acting as nominee and therefore they arranged for the cars to be available to them in their own right at their own expense and not provided by the company.

The contracts for the two Mercedes CLS55 four door cars were in the name of the company and signed by the directors who were not required to give personal guarantees. The directors personally paid all of the costs of the cars such as leasing, petrol, insurance, road tax, repairs and maintenance but the company had reclaimed one half of the input VAT being a private use restriction. This was a mistake and was corrected on challenge by HMRC.

Arguments:
The Appellants argued that although the company had contracted with the leasing company it did so as nominee of the individual directors. The error on VAT on the lease payments was corrected as soon as it was noticed. The second argument was that these transactions had in fact been leased and paid for by the individuals who were also the registered keepers. The cars had not been included in the company's accounts as assets leased by the company because payments were settled to the individuals' bank accounts. The directors also argued that the moral or commonsense viewpoint was that they had paid the full cost of the car and it was nonsensical that a tax liability should be manufactured in such circumstances.

HMRC argued that the individuals could have leased the vehicles directly but arranged to do so through the company. As such the vehicles were supplied by the employer and so a full benefit in kind charge arose. Section 117 is a deeming provision that deems the car to be available by virtue of the employment

whether it is or is not and the only escape in Section 118 is if an individual was to supply the vehicle in the capacity of that individual.

Decision:
The company was bound by the contract with itself and the leasing company and as such the company supplied the vehicles to the directors. Neither the leasing company nor the employer company could force payment from the directors although in fact the directors had met all of the costs directly from their bank accounts. There was no evidence which would support a nominee agreement or that the company was acting as agents. There was therefore a liability to account for tax and NIC on the benefit in kind enjoyed by the directors of the use of a company car.

An interesting footnote to the decision in favour of HMRC was at paragraph 49 where it says that the legislation recognises the possibility of reimbursement of costs by the user of the car and such reimbursement is taken into account in the computation of the benefit. This would appear to be further conformation of the application of an Extra Statutory Concession first visible in the 2009 case of Whitby. The law actually requires it to be a contractual condition of the car being available for private use before contributions from the individual can be deducted but paragraph 49 suggests that the Tribunal is approving concessionary treatment that the costs borne by the user can be deducted in the computation of the benefit.

Commentary: The result of deeming a benefit in kind to apply to directors who were in fact bearing the full economic cost themselves is an unfair result. Effectively it is double taxation but the strict interpretation of the law produces this result. It is clearly HMRC policy and practice to apply the deeming provisions strictly and in the next but one case (of *Cooper & Others (Leaside Timber and Builder Merchants Ltd) v Revenue & Customs [2012] UK FTT 439.*, the result is even more unfair but it illustrates that there can be a punitive fiscal consequence for overlooking this problem.

2.5.3 Tax planning a car which failed In G R Solutions Ltd v Revenue & Customs [2012] UKFTT

234*,* it was the director personally who had initially purchased the vehicle and subsequently transferred a 90% interest to the company. Mr Hall, a director of the company bought a BMW X5 costing £53,645. He then transferred 90% to the company for £48,636 arguing that his 10% share which approximated to his annual private mileage meant that the company was not making the car available to him. This argument was rejected with the court finding that the company was liable to pay class 1A national insurance contributions in respect of car and fuel benefit totalling £19,726. Mr Hall's argument that the car was available to him by virtue of his ownership rights and contribution towards running expenses prevented the fiscal fiction of car benefit rules applying was rejected.

HMRC's argument was that when the employee uses the car for private purposes the employer's 90% share of the car is being made available to the employee at that time and it is so made available by reason of his employment.

2.5.4 A worrying tax trap catching the self employed

The latest development has emerged with the decision of **Cooper & Others (Leaside Timber and Builder Merchants Ltd) v Revenue & Customs [2012] UK FTT 439.** In this case, a parallel service partnership was funded in part by the partners contributing capital which enabled this partnership to buy cars. The sole income of the service partnership derived from the trading company. The service partnership charged a management fee for the services provided by the partners and three employees. The sole customer of the partnership was the limited company.

The partnership provided cars and the overhead expenses including fuel to each of the partners. Each partner faced a disallowance for the private use that they made of the vehicle and its associated running expenses but HMRC went a stage further and said that as two of the partners were directors of the building company the provision of the cars came from the directors' employment. This seems to be taking the fiscal fiction created by the car benefits legislation to an unacceptable extreme. The consequence produces substantial amounts of tax because the company owed class 1A National Insurance of around £70,000 and the individuals faced a tax bill of around £145,000.

The Tribunal confirmed that the partnership is independent from the company and carries on its own account to commercial business but that business is wholly dependent upon the company, its sole customer. The Tribunal took the view that the management fee paid by the company to the partnership was more generous than would pertain if independent parties were acting at arm's length. With this in mind, the Tribunal found as a fact that the management charges comprised some of the running costs and depreciation for the cars and so argued that the company made available the cars to the directors for private use.

This is of course an outrageous outcome but it shows that in applying the strict letter of the law taxation can be very unfair. The directors have been charged in part by a disallowance in the computation of the partnership profit for their private use but they now face a double charge under the benefits in kind legislation because the Tribunal has interpreted the words *"by reason of his employment"* as much wider than common sense would suggest. In this case, even though the cars were bought and paid for by a partnership which is quite separate from the company, the argument is that all of the costs of providing and fuelling the cars were being met by the company through the management charge that the company paid to the parallel service company.

This decision has the potential to affect commercial arrangements which have been put in place. A key finding of the Tribunal is that the fees paid by the company to the partnership were excessive if one applies a test of what would be commercially reasonable in dealings between independent parties acting at arm's length. The Tribunal concluded that the cars in question were made available and the car fuel provided to each of the individuals by reason of their employment by the company. Even though the individuals were meeting all of the costs of the vehicles from what was their own money, the Tribunal concluded that there is no basis for reducing the cash equivalent of the benefits received by the partners.

Members of a trading partnership which derives income from a trading company in which an individual partner or partners has a material interest need to take note of this decision. If you think you or one of your clients are affected, you or your client should seek advice, as a matter of urgency, from an experienced tax adviser.

In principle, all employees who have saved their wages to buy and run a car could find themselves facing another tax cost on a car benefit. It won't happen if common sense prevails.

The Tribunal has decided in favour of HMRC but in so doing they have illustrated that the interpretation of the car benefits legislation has gone beyond what can be acceptable. To be taxed on a fictitious "*benefit"* that was paid for using your own hard earned money is absurd.

2.6 Other risks and matters to be considered for structure

This may appear to be all doom and gloom but it is really just a health warning to consider carefully the business vehicle which is best suited to conduct the business. Some advisers believe that tax considerations are and should be largely irrelevant and might advise that protecting the proprietors wealth

should be the driver. They might recommend that as soon as the business needs to take on an employee, the financial protection that limited liability provides means incorporation would be the preferred vehicle.

Other risks should be identified and considered carefully when deciding on which structure is most appropriate to conduct business

Consideration of other tax and non-tax issues is then carried out separately to overlay these basic figures.

Generally, setting up a successful business succession plan involves the following six stages:

2.6.1 **Survival** - Once the business has survived the start-up stage and possibly even as early as the commencement of the business, you should consider a business succession plan. This may be the exit strategy mentioned earlier and may involve considering other taxes including IHT. Entitlement to BPR and APR may be important considerations

2.6.2 **Commitment** – A business may start with enthusiasm but advancing years may adversely affect the proprietors' enthusiasm for the activity. For example, a successful mechanic may love working on cars when young but may find the prospect of such heavy work in difficult conditions less attractive as he ages

2.6.3 **Recruitment** - Recruiting good people always pays dividends and is a key area of importance in succession planning. However, the decision to recruit an employee is a step change in responsibility and compliance cost. Some argue that the protection of limited liability should always be obtained if employees are to be recruited

2.6.4 **Development** – The pace of change means that most businesses will need to invest in training and developing staff. Investing time in developing family members, key employees, and management team members, and allowing them to exercise authority and control, will be vital to success

2.6.5 **Selection** - Selecting a successor or successors and having a clear exit strategy from an early stage in the business will help.

2.6.6 **Implementation** - In implementing the succession plan, you must be ready to step aside and allow the successor(s) to take over. You must be prepared to take on new challenges in retirement, knowing that your financial future is secure. An exit strategy may involve selling the business and care should be taken to identify and protect any entitlement to entrepreneurs' relief for CGT (giving an effective rate on the sale of a business or part of a business of 10%). If passing the business to family members gifts holdover may be apposite and protecting BPR/APR to minimize IHT may be important.

In concluding this chapter on structure, it is important to remember that tax rates change frequently and that the current tax regime might be significantly different from a future one. Thus, the tax tail should not wag the commercial dog and a holistic approach should be adopted carefully evaluating the risks and benefits of the different structures over the expected life of the business.

2.7 Summary

The holistic approach would require other considerations which might include:

- Limited liability - before the benefit in tax reduction this was the main reason for incorporation because should a company fail the liability of the shareholder is supposedly limited to the amount unpaid on the shares (if any). However, banks now demand personal guarantees of directors such that the value of Limited liability has eroded. The tax regime (and NIC) now have provisions to make directors and shareholders personally liable for tax lost knowingly through non compliance. For some, the ability to call onself a 'director'' may provide enhanced status.
- Different categories of shares can enable different levels of payment to be allocated; advantage being taken of the different personal tax circumstances of individual shareholders. This must

inevitably carry a health warning as HMRC are more likely to risk assess a higher score if there are dividend waivers and different categories of shares. Greatewr care is essential to ensure that dividends are properly declared and that there are sufficient distributable profits at the time the dividend is voted.

- Dividend waivers enable transfer of income - possibly from a higher rate tax payer to lower rate. Not possible to transfer income of self-employed unless a partnership is formed.
- IHT Planning - a company enables greater flexibility; on death the company continues to exist as a separate legal entity. And if the company is trading BPR may be available to mitigate IHT liability
- Depending upon the type of business it might prove easier to sell shares rather than the business and business assets if not a Limited company.
- A director can borrow from the company with no need to attend a bank interview or pay high credit card/loan interest. Shareholder consent is needed under Companies Act 2006 if the loan exceeds £10,000 (s207 - small amounts limit) and there is a corporation tax charge of 25% if the loan remains unpaid nine months after the year end (s455 CTA 2010). If the loan is in excess of £5,000 and is interest-free or less than 4% there will be a taxable benefit in kind charge for the director and an NIC charge for the company.
- Tax free employee benefits and incentives can be provided with the company obtaining tax relief thereon - not possible for the self-employed employer (see above list)
- Where the business property is held outside of the company in the directors name the director can extract funds from the company in the form of rent - no PAYE or NIC issues. There will usually be a mortgage such that rental income will ensure immediate tax relief for interest paid. No Entrepreneurs Relief is due on the sale of the property as it will be deemed an investment property.
- Overlap relief available on cessation of self-employed trade.
- Transfer of trading loss - relieved against salary then against dividends so long as business exchanged for shares. At least 75% of the shares of company must be retained by the shareholder throughout the tax year in which the loss is relieved. (S86 ITA 2007)

3. Choice of Accounting date

It is important to consider the workload implications as well as the cash flow implications when choosing the accounting date to which annual accounts will be prepared.

3.1 Companies

Common sense indicates that in any activity which has seasonal variation, it would be unwise to choose an accounting date at a busy time. For a limited company, the tax is due and payable 9 months after the end of the accounting period.

3.2 Sole traders and partnerships

The general rule is that the basis period for any given tax year is the 12-month period that ends with the accounting date in that tax year (ITTOIA 2005, s. 198(1)). In practice, the majority of basis periods are simply decided under this general rule. Again common sense is required and the accounting date should not coincide with a busy period when resource exhaustion might be a problem.

Income tax is charged, in relation to business profits, on ‘the full amount of the profits of the tax year’ (ITTOIA 2005, s. 7(1)). The legislation for the self employed operates a system of ‘basis periods’ whereby the profits arising in a defined basis period are treated as if they were the profits of the tax year (s. 7(2)).

The general rule will not apply, however, if the basis period is to be determined under any of the other following provisions of the Income Tax (Trading and Other Income) Act 2005 (‘ITTOIA 2005’):

- Section 199 (first tax year) – The basis period for the year in which a person starts to carry on a trade, profession or vocation is the period from the start of trading to 5 April at the end of the tax year (ITTOIA 2005, s. 199).
- Section 200 (second tax year) – The basis of assessment for year 2 is dependent on the choice of accounting date. Five possibilities arise:

(1) the business ends in year 2 (not considered further as the webinar is about expanding businesses rather than a tutorial on basis of assessment);
(2) the accounting date in year 2 falls less than 12 months from commencement as in the example of Ben below;
(3) the accounting date in year 2 falls not less than 12 months from commencement ;
(4) there is a change of accounting date in year 2;
(5) there is no accounting date in year 2.

- Section 201 (tax year with no accounting date)
- Section 202 (final tax year)

3.2.1 Commencement Example

Ben starts trading on 1 February 2009 and draws his first accounts up to 31 December 2009, making a profit of £25,000. His next accounts to 31 December 2010 have a taxable adjusted profit of £30,000. His next accounts for the year to 31 December2011 have a tax adjusted profit of £35,000. The first tax year in which he is trading is 2008–2009, i.e. the year ended 5 April 2009. Strictly speaking the tax requires the time apportionment to be calculated on a daily basis and so the first period of accounts is 334 days (11 months). In practice HMRC will accept an apportionment on a reasonable basis including weeks or even months.

Strictly, Ben's taxable profit for 2008-09 is (28+31+5= 64) 64/334 X£25,000 =£4790

His second year of profit 2009-10 is based on the first 12 months which would be:

- 334 days to 31 December 2009 £25,000
- 31 days from YE 31 December 2010 (31/365 X £30,000) £ 2,547
- Total assessed £27,547

Ben's third year is 2010-11 and will be based on the profit in the 12 months to 31 December 2010 (£30,000). Ben has been assessed on a total of £62,337 but has only made £55,000. The difference is overlap relief which can be relieved when the business ceases of there is a change of accounting date. The double assessment is a period of 95 days (01 January to 5 April)

Choosing a year end is an important issue for any business. As mentioned above, it is common sense to choose an accounting date at a quiet time of the year when stock and work in progress are low and the proprietor has the personal resource to perform the necessary tasks.

With steadily rising profits, there is a cash flow advantage in selecting a year end of 30 April rather than 31 March. In Ben's example above his actual income for 2010/11 is (using a monthly approximation) £31,250 but he is assessed on only £30,000. Choosing an accounting date of 30 April may prove beneficial for an expanding business. As it maximizes the time between the profit being earned and the tax being paid.

But the underlying principle is that the business will pay tax on the profit which it has earned. All unused overlap relief will be available to set against taxable profits at the time a business permanently ceases.

This means that when the business ceases and an accounting date of 30 April has been used, the final year's assessment could be large and a bit if a 'sting in the tail'.

3.3 Planning the profit

With the annual investment allowance set at its current generous levels, it is relatively easy to plan to achieve certain levels of taxable profit by strategic investment in qualifying plant and machinery.

Any new expenditure on plant and machinery assets bought after 1 April 2008 for Corporation Tax, or 6 April 2008 for Income Tax qualifies for AIA, apart from these exceptions:

- cars - see the section below on capital allowances on cars
- plant and machinery previously used for another purpose, for example, a computer used at home and introduced into your business
- plant and machinery gifted to your business
- expenditure incurred in the accounting period in which your business ceases

From 1 January 2013 to 31 December 2014 the annual investment allowance is £250,000

Other ways of reducing taxable profit might include:

- Working less (some may find this an attractive option if they wish to consider their work life balance)
- Pension contributions

Using a parallel service company but payments to this must be wholly and exclusively for the purposes of the trade to qualify as a deductible expense. This also carries risks if HMRC think that it is being used for tax avoidance but to someone approaching the profit of £100,000 and therefore an effective marginal rate of 62% as personal allowances are clawed back (profits between £100,000 and £118,880 for 2013/14 suffer a 62% rate of tax). Where profits exceed £150,000 and the top rate (effectively 47%) applies, a parallel service company might be an attractive option as it pays tax on its profits up to £300,000 at 20% only.

4. VAT registration: an important decision

4.1 Introduction

VAT is a tax on the final consumer and as a result with VAT at 20% standard rate, there may be significant commercial implications to being VAT registered. The market can often determine the price which the consumer wishes to pay and if so a trader who is VAT registered may be placed at a competitive disadvantage.

Once turnover exceeds the threshold of £79,000, registration is mandatory. If the business customer is also VAT registered and making taxable supplies, it makes sense to consider voluntary registration to enable input VAT tp be recovered. Similarly, as we shall see in the later case of Mrs Khoshaba, if there is substantial input tax incurred before the commencement of trading, early registration could have saved a lot of money. No one can afford to get this aspect of tax compliance wrong. Mistakes will prove commercially expensive and may also carry punitive penalties for non compliance.

Plan ahead and know when to register for VAT. Be clear about the impact of VAT on the business turnover. For example, a guest house supplying bed and breakfast will be less competitive to end user holiday people if it has to charge VAT. It is important to ensure the business plan takes account of the

impact of registering for VAT. For example, if services are provided to the public, registering for VAT may have major implications for the pricing structure. A plumber dealing direct with the public might have very low input tax and may decide to keep his turnover below the threshold and not register for VAT. But a plumber working as a subcontractor to a large construction company which can recover its VAT should register as his customer can recover the input tax and so it is not a cost to the customer.

Manage the VAT within the business' cash-flow. Many businesses take advantage of the VAT they've collected, making it work for them before it must be paid to HMRC. However, it needs to be managed carefully because delays will result in poor compliance records and possible penalties. If possible, avoid spending the VAT which has been collected so that all VAT due can be paid whenever due. The VAT collected (output tax), less the reclaimable VAT (input tax), belongs to HMRC and should be paid when the VAT return is due.

4.2 Planning for VAT registration

Generally, a person making taxable supplies to other taxable persons is better off by registering for VAT, even if his turnover is not large enough to make registration mandatory. This enables him to recover input tax on many costs, while the output tax charged can be recovered by the customers.

A person that starts supplying the general public may wish to defer registration. It is possible to make significant supplies free of VAT before registration becomes mandatory.

Care is often needed to avoid permanent loss of input tax on services acquired before registration due to the six-month deadline. The recipient of a composite supply may find, as in the case of Mrs Khoshaba summarized below, that the composite supply of refitting a shop was treated as a service and so the input tax was denied as being out of time.

4.2.1 Refurbishment of a dilapidated property was a supply of services for VAT

Khoshaba t/a Cinnamon Café v Revenue & Customs [2013] UKFTT 481 concerns whether preregistration expenditure could be recovered. The issue was whether the costs incurred in refurbishing and converting a property previously used as a hairdresser into a café were a supply of services or goods. If the supply was for services, the input VAT incurred was out of time but if it were goods it could be recovered.

Mrs. Khoshaba obtained a lease of premises which had previously been used as a hairdressers. She had the premises converted by her husband's building company in order to operate a café, which commenced trading on 4 June 2007. Initially it was not VAT registered.

HMRC investigated her business in July 2010 and decided that it ought to have been registered with effect from 1 October 2008. There has been no appeal against that decision.

The first VAT return covered the period from 1 October 2008 to 31 May 2011. In this return some £46,757 worth of input tax was reclaimed (against a declared liability to output tax of some £48,000). HMRC required the taxpayer to breakdown and justify this input tax reclaim.

The main issue in dispute was an invoice which included £22,050 in VAT from Lindfield Building Contractors Ltd, Mrs Khoshaba's husband's company. The invoice was dated 30 July 2007. This was more than six months before the effective date of registration but less than 3 years before that date. It was accepted that the effect of the Value Added Tax Regulations 1995 Regulation 111(2) was to permit a taxpayer to recover pre-registration input tax incurred on supplies to the business in the four years prior to

registration in so far as they were supplies of goods but only six months in so far as they were supplies of services.

The conversion of the property took approximately 4 months to be completed after possession of the premises was given by the landlord. The first month was spent in planning, making estimates, doing surveys and appointing architects and surveyors. The physical work to the shop took about two and half months.

The work to the ground floor shop involved ripping out the hairdressing fixtures such as the sinks, removing load bearing walls and replacing them with structural beams, replacing and enlarging the existing toilet facilities (including the necessary drainage works), re-plumbing and re-wiring the entire premises.

Once this was work was done and made good, counters and units which were built to order by a joinery company were installed. Fridges were purchased and installed. New wood flooring was laid.

A new air conditioning system was sub-contracted, and the sub-contractors installed it. A canopy and shutters at the front were also commissioned by Lindfield and installed by the company which made them.

The tribunal concluded that a significant part of Lindfield's invoice represented the cost of goods and a significant part represented the cost of services. The first question is whether Lindfield made a single supply to the appellant or a number of supplies. In other words, did it supply the prefab goods separately to the works of refurbishment of the premises? The tribunal concluded that this was a single supply in the sense that the elements which comprised the supply were so closely linked that they objectively formed a single indivisible economic supply.

At paragraph 36, the tribunal went on to conclude that the supply was the service of providing a refurbished shop; it was not a supply of goods (the pre-fab units) with incidental installation works. The claim to recover input VAT did not fulfil the requirements of Regulation 111(4) because the invoice was for services which were provided more than six months before the registration date and therefore HMRC were correct to refuse to exercise their discretion to allow the recovery of the pre-registration input tax on the Lindfield invoice.

There were other subsidiary issues to this case but in the context of a non compliant taxpayer whose failure to register at the right time will suffer penalties, the decision demonstrates that in tax the strict interpretation of the law can be expected. In a project similar to that of Mrs. Khoshaba, an intended trader registration might have enabled all of the input tax on the services obtained to be recovered.

4.2.2

A contrast to the Khoshaba case is in **Rayner & Keeler Ltd v C & E Commrs [1994] BVC 194**. The court held that contracts for fitting out shops involving the supply of both services and goods were multiple supplies, not as single supplies of shop fitting services into which the incidental supply of goods was subsumed.

As discussed below in dealing with pre-registration input tax, a distinction is made between goods and services. On that basis, the taxpayer could not reclaim input tax on supplies of services received before 1 March 1988. The point at issue was:

(1) whether the shop fitting contracts were contracts for the supply of services which incidentally included supplies of goods, so that no input tax could be deducted; or

(2) whether the various items were to be treated as separate supplies of goods or services as the case might be, so that the input tax paid in respect of the goods could be deducted.

The court held that the shop fitting was a substantial and complex commercial relationship involving multiple separable supplies of goods and multiple separable supplies of services. Accordingly, while a supply of goods might be subsumed into a supply of services, the substance and reality of the contracts were that the contracts comprised multiple and separable supplies of goods and multiple separable supplies of services. The case was remitted to a tribunal to find which of the separate supplies were supplies of goods and which were supplies of services.

4.2.3 Voluntary registration

Even if not required to do so, a person may choose to register for VAT if either:

(1) he makes taxable supplies, but the value of those supplies does not exceed the limits referred to above; or
(2) he is carrying on a business and he intends to make taxable supplies and can satisfy certain evidential requirements (VATA 1994, Sch. 1, para. 9).

Registering voluntarily for VAT may be beneficial if it enables the recovery of significant amounts of input tax. This might arise when there is significant expenditure incurred prior to or at the start of a business and the input tax on that expenditure is sought to be recovered.

4.2.4 Preregistration input tax

Relief is available, subject to the four-year cap, on repayments for certain input tax incurred before the effective date of registration (or, in the case of a limited company, before incorporation; Value Added Tax Regulations 1995 (SI 1995/2518), reg. 111).

The cap was extended to four years from three years, from 1 April 2009.

The reclaimable VAT is:

(1) VAT on supplies of goods obtained if the goods, such as stock and fixed assets, are still on hand at the date of registration, either in their original state or incorporated into other goods, but subject to the four-year cap.
(2) VAT on supplies of services obtained within six months before the effective date of registration.

Where a claim concerns input tax on stock and assets obtained not more than four years before registration, the trader should compile a stock account showing:

(1) quantities purchased;
(2) quantities used in making other goods;
(3) date of purchase; and
(4) date of disposal (either of the original goods or of any goods made from them) (Notice 700, para. 11.1 (2012 edn))

(Value Added Tax Regulations 1995, reg. 111(4)(a).)

The trader lists all the services received no more than six months before registration in respect of which a claim is being made, showing:

(1) their description
(2) date of purchase; and

(3) where appropriate, the date of their disposal. A service is ‘disposed of’ if it consisted of work done on goods which were then disposed of

(Value Added Tax Regulations 1995, reg. 29(1A) and 111(4)(b)).

4.3 Cash flow and VAT

Persons that regularly receive a VAT repayment often request monthly VAT returns so they receive earlier than if they submitted quarterly returns.

At HMRC's discretion, a company which primarily exports goods (zero-rated) can apply for monthly returns, since it is a repayment trader and frequent returns improve cash-flow. HMRC usually refuses the application where a corporate group that would not generally be in a repayment position creates an export company for that purpose.

In R (on the application of BMW AG) v R & C Commrs [2009] BVC 221 (summarized below), HMRC required an export company to move from monthly to quarterly accounting under Value Added Tax Regulations 1995, reg. 25. BMW applied for an order under judicial review quashing that requirement. BMW argued that it was being discriminated against by comparison with third parties which exported goods and which could therefore enjoy better cash-flow on exports. BMW was effectively being penalised for having non-export activities.

BMW ag & Anor –v- HMRC [2009] EWCA Civ 77

Point at Issue: Whether HMRC had the right to change an associated companies VAT return period to deny it a cash flow advantage

Facts: BMW AG is a German incorporated company registered for VAT in the UK. It is a repayment trader which purchases cars from the manufacturer BMW UK Manufacturing Ltd (UKM) another member of the BMW corporate group. They are described as "associated" companies. BMW AG exports most of the cars it purchases from BMW UKM to places outside the United Kingdom. No money leaves that group until the output tax is paid by the supplier. The BMW group received a payment of approximately £30m, which it held for about two months before repaying it. It also received another payment of approximately £30m from the Exchequer which it held for around one month before repayment.

Argument: The justification for the distinction drawn between associated and non-associated traders appears to be that to permit monthly accounting to a repayment trader associated with its supplier brings an "unjustified and unintended benefit" at the expense of the Exchequer. HMRC was rightly concerned that price manipulation might be abused but that was addressed in 2004 by Transfer pricing rules contained in Schedule 28AA Income and Corporation Taxes Act 1988 which impose direct tax charges where arrangements between associated companies, including those relating to payment of interest, are not on arm's length terms.

Decision: LJs Pill Lloyd and Moses upheld *Tugendhat J’s decision from the High Court* [2008] EWHC 712 (Admin). The delay in paying VAT collected can give traders a cash flow benefit. The later he pays his suppliers, and the sooner he is paid by his customers, the greater the cash flow benefit to the trader, and vice versa.. As LJ Moses said:

“…it is for HMRC and not for the court to decide how best it may ameliorate the cash flow disadvantage it suffers. It alone is entitled to conclude which factors are relevant in order to achieve that objective, subject only to *Wednesbury* review……I agree with Tughendhat J that the policy adopted by HMRC was

neither unlawful nor irrational.” So BMW AG lost its appeal and will have to align its VAT accounting with that of the manufacturing company, denying it the cash flow advantage.

Commentary: The power to allow a repayment trader to account for VAT on a monthly basis is central to this appeal. A trader permitted to account for VAT monthly must file its return within one month of the end of the accounting period including any claim for repayment. The input tax should be repaid within 30 days, if HMRC is to avoid liability to make an additional interest payment, "repayment supplement". BMW AG challenged the decision of HMRC to withdraw monthly accounting contending that HMRC had no such power and that the policy was irrational and discriminatory.

BB 12/05 HMRC to exercise their power to allow VAT periods between associated businesses where there is little or no commercial rationale for the VAT period 'stagger' between the associated businesses besides obtaining the cash flow advantage.

Regulation 25(i)(a) Vat Regulations 1995 prescribes a quarterly period but with discretion to allow monthly or to direct to vary AP dates.

This decision will have significant implications for many groups and associated companies which have taken advantage of routing zero rated supplies through a monthly repayment trader.

4.4 Fragmentation of a business

Once a person is registered, he must account for output tax on all the taxable supplies he makes in the course of furtherance of any taxable business activity which he has. It is irrelevant that the businesses may be unrelated and different.

This can be a potential tax trap. For example, a husband and wife may be in partnership farming and so registered for VAT but the wife may conduct a B&B business using the excess rooms in the large farmhouse. Structured properly with it being clear that different legal persons are conducting the two business activities, the B&B need not charge VAT if its turnover stays below the registration threshold. Making a mistake could be expensive.

4.4.1 Unintended consequence

James and Ben run a sandwich bar working part time on weekday mornings in partnership sharing the profits and are not VAT-registered.

James buys cars at auction and repairs these cars as a sole trader and is not VAT-registered. The turnover from each business is a little under the registration limit.

However, if Ben dies leaving his share of the sandwich business to James, James must VAT-register and account for VAT because the turnover of the combined business now exceeds the registration threshold even though the businesses are unrelated and so different.

4.4.2 Planning to fragment a business

Persons, especially those making standard-rated supplies to the general public, sometimes try to split a business into parts, so that one part or more than one part makes supplies which are under the registration threshold. If this works, a lower price might be charged than that charged by VAT-registered competitors. Alternatively, the same price might be charged, but usually the profit will be greater than that made by the VAT-registered competitors.

Splitting a business is especially profitable where the main inputs are not VATable, such as wages or zero-rated food. Some people have formed several companies to trade from a single property, with each company trading on a different day and keeping below the registration threshold (often carry out food shops or launderettes). Each company is a separate legal person and so the activity of one company one day is not aggregated with the activity of the associated company unlrdd HMRC issue a direction.

Hairdressers have rented chairs to stylists where each stylist operates until separately and independently and claims not to be part of the main hairdressing business. Not surprisingly, HMRC frequently challenge such arrangements and the law was changed to make chair rentals standard rated.

Sometimes a man has VAT-registered business while his wife ran an independent business within the ambit of her husband's business activities. This is often found in the licensed trade: the wife of the licensee of a public house provides catering within the licensed premises. The husband is the registered taxable person and the turnover from the catering business is under the registration threshold (Prottey t/a The Lord Nelson [2001] BVC 4,024; Fraser [2001] BVC 4,032).

With the standard rate of VAT now at 20%, persons, especially those selling to the general public, sometimes try to split a business into parts, so that one part or more than one part makes supplies which are under the registration threshold. If this works, a lower price might be charged than that charged by VAT-registered competitors. Alternatively, the same price might be charged, but usually the profit will be greater than that made by the VAT-registered competitors.

Splitting a business is especially profitable where the main inputs are not VATable, such as accommodation, wages or food. Hairdressers and Laundrettes are potential abusers of fragmentation schemes in which persons have formed several companies to trade from a single property or different chairs, with each company trading on a different day and keeping below the registration threshold.

John Smith trading on his own account is a different legal 'person' from John Smith trading in partnership with his wife. Equally, if John Smith trades on his own account and his wife also trades on her own account, they trade in partnership and they have a separate limited company John and Mabel Smith Ltd, there are four different legal entities trading and all might stay under the VAT registration threshold currently of £79,000 pa

HMRC can make a direction to deem the persons named in it ('the constituent members') as being one person (a 'single taxable person') for VAT purposes, and so registerable from the date of the direction (VATA 1994, Sch. 1, para. 2). Such an original direction cannot be made retrospectively. HMRC can make the direction if they are satisfied that:

(1) each named person makes taxable supplies;
(2) the activities in the course of which the supplies are made form only part of a business described in the direction, the other activities of that business being carried on concurrently or previously (or both) by the other persons named in the direction; and
(3) when all the activities of the business are considered together the person carrying it on is liable to be VAT-registered.

HMRC no longer need to be satisfied that 'the main reason or one of the main reasons' for splitting the business activities is to avoid the need for one (or more) of the named persons to be VAT-registered. Whether it is reasonable to issue a direction will really be a matter of judgement dependent on the facts in individual cases. But if there is a strong interdependence between the allegedly separate activities and common records and bank accounts, the probability of a direction increases. Conversely, different

persons conducting businesses that are entirely unrelated need not lose sleep about this anti-avoidance provision.

In **A D and J Forster v Revenue & Customs [2011] UKFTT 469,** the issue was whether a bed and breakfast business conducted by the farmer's wife at Parsonage farm should be aggregated with the registered farming business conducted in partnership by the husband, wife and son.

Parsonage Farm has been owned by the Forster family since 1936. The farm comprises 150 hectares and is wholly arable. Mrs Foster, aged 67, plays no active part in the farming activity which is mainly done by the son who lives in a house in the nearby village. Mr and Mrs Forster moved into the farmhouse in 1971. Mrs Forster started the B&B in 1975 as she wanted to earn some money working from home independently from the farm.

The annual turnover of the B&B for the last five or six years has been approximately £6000 to £8000. The farming partnership and the B&B maintain separate books of account. Mrs Forster has her own bank account, which she uses for the B&B business. The B&B covers the costs of window cleaning, laundry and maintenance of the AGA in the farmhouse and also a gardener over the summer months.

The farmhouse is on two floors. On the first floor are four bedrooms (one of which has an en-suite bathroom) and a "family" bathroom. One of the bedrooms is used by Mr and Mrs Forster, and the other three are used for the B&B. When they are not in use for the B&B, the bedrooms are used by Mr and Mrs Forster's personal guests (such as their grandchildren). On the ground floor is a dining room (which is used by the B&B to serve breakfasts – when not in use for the B&B, it is used privately by Mr and Mrs Forster), a sitting room (used privately), a kitchen/conservatory (used privately as well as for preparing breakfasts for the B&B), a sewing room (used privately) and a "summer" room (used privately). There are also a back kitchen and pantry.   The farmhouse forms part of the farm's assets and there is an adjustment to disallow private use of overheads – a key finding of fact because it meant that the partnership was not meeting the cost of the farmhouse.

HMRC contend that the farm and the B&B are not sufficiently at arm's length from each other, and that they do not have a normal commercial relationship with each other – and that the reality is that there is one business – being the business of farming activities *and* the bed and breakfast. Without the farm, the B&B would not be a viable business.

There was no evidence that the farmhouse was used by the farming business – indeed the evidence was that the farm was now run from the son John's home and the Finn cabin which contained the office.   HMRC did not take into consideration the fact that the B&B business had been started by Mrs Forster in the 1975, when her parents-in-law were the main partners in the farm. The B&B had been started by Mrs Forster independently of the farming business for entirely legitimate and understandable reasons.

The B&B is not closely bound to the farming business by financial, economic or organisational links. The FTT decided that the HMRC officer could not reasonably have concluded that it was appropriate to make a direction. These were separate businesses and so the appeal against the direction was allowed.

My thought process is to question how this case ever came to the Tribunal. Surely there is someone within HMRC who has an iota of common sense? The officer had little justification for his position and his line manager should have stopped this. Having made the error, the taxpayer's appeal should have succeeded at the internal review stage. The fact that this case appeared before a tribunal is worrying because it indicates that HMRC internal review procedure is not working properly.

What is worse is the pettiness of the HMRC contention and arguments. Even taking the higher figure of turnover of £8,000 the issue is about £1,333 of potential VAT. The cost of the appeal will be more

expensive than the VAT at issue. The decision is worth a read even if only to identify the parties who demonstrably lacked judgement.

In Howard Rowland Patrick And Jennifer Rosemary Patrick v Revenue & Customs [2011] UKFTT 865, East Hook Farm in Pembrokeshire is run as a partnership by Mr Howard Patrick with his wife, Mrs Jennifer Patrick. The business, which is VAT registered, includes the traditional farming activities of beef and sheep production as well as a haulage operation and the provision of self-catering accommodation in an outbuilding that has been converted into a holiday cottage.

Mrs Patrick was a sole trader with turnover of £61,000 offering a B&B accommodation. The faremhouse is used to accommodate B&B guests with two additional rooms, in the same building as the self-catering cottage, used for those guests unable to use stairs or requiring disabled access.

Schedule 1 of the Value Added Tax Act 1994 provides:

> *1A(1) Paragraph 2 below is for the purpose of preventing the maintenance or creation of any artificial separation of business activities carried on by two or more persons from resulting in an avoidance of VAT*
>
> *(2) In determining for the purposes of sub-paragraph (1) above whether any separation of business activities is artificial, regard shall be had to the extent to which the different persons carrying on those activities are closely bound to one another by financial, economic and organisational links.*
>
> *2(1) Without prejudice to paragraph 1 above, if the Commissioners make a direction under this paragraph, the persons named in the direction shall be treated as a single taxable person carrying on the activities of a business described in the direction and that taxable person shall be liable to be registered under this Schedule with effect from the date of the direction or, if the direction so provides, from such later date as may be specified therein.*
>
> *(2) The Commissioners shall not make a direction under this paragraph naming any person unless they are satisfied—*
>
> > *(a) that he is making or has made taxable supplies; and*
> >
> > *(b) that the activities in the course of which he makes or made those taxable supplies form only part of certain activities, the other activities being carried on concurrently or previously (or both) by one or more other persons; and*
> >
> > *(c) that, if all the taxable supplies the business described in the direction were taken into account, a person carrying on that business would at the time of the direction be liable to be registered by virtue of paragraph 1 above;*

HMRC issued a direction after establishing the facts as follows:

(1) The bank accounts for the farm partnership and B&B are both joint accounts in the name of H & J Patrick although the B&B account is “T/A East Hook B&B”.

(2) Putting the holiday cottage into the partnership keeps the B&B below the VAT registration limit.

(3) Although separate records are kept, the same bookkeeper is employed for both businesses.

(4) Money is sometimes transferred from the B&B bank account to the farm account to ease cash flow and is then transferred back (Mr Harrison did however accept when asked by the Tribunal that he would not necessarily expect to see formal arrangements in place where, as in this case, the

parties concerned were husband and wife and that he had taken this into account when considering whether a direction was appropriate).

(5) The self-catering cottage and B&B were included on the same website where they are presented as one business.

(6) Although advertised in separate sections of the *Farm Stay* website and brochure they appear to a potential customer to be part of the same business.

(7) The same building (a converted outbuilding) is used for both B&B and self-catering.

(8) There is a combined insurance policy in the names of both partners which specifically mentions the B&B.

(9) The farm/haulage business is loss making and would not be viable without the holiday business.

(10) The properties are all owned jointly by Mr and Mrs Patrick and there are no charges for rent or for the use of fixtures and fittings by Mrs Patrick (However, when giving evidence Mrs Patrick told us that she did pay rent to the farm partnership for the use by the B&B of the two rooms which are in the same outbuilding as the self-catering cottage).

(11) The purchase of the farm and refurbishment of the farmhouse to make it suitable for B&B was financed by mortgages in the joint names of Mr and Mrs Patrick together with the proceeds of sale of their previous property.

(12) Mrs Patrick deals with all the bookings for the B&B and self-catering.

(13) The same invoice book is used for the B&B and self-catering.

In a way, this case is an illustration of how not to separate a business. However, having regard to financial, economic and organisational links closely binding the B&B and farm, particularly the self-catering cottage, there was an artificial separation of business activities which resulted in the avoidance of VAT. For this reason it was reasonable for HMRC to issue the direction that Mr and Mrs Patrick be registered for VAT as a single taxable person with effect from 22 February 2010. Note that the direction is prospective and not retrospective.

5 Conclusion

Although tax should never wag the commercial dog, arranging structures and activities in the most tax efficient way can help a business preserve its working capital and expand.

However, the more sophisticated the planning, the greater care the business needs to take in ensuring proper compliance with it tax obligations. Mistakes can prove costly, even punitive.

The proprietor’s exit strategy and long term plans should form the basis of any business plan but this should also be as flexible as possible. Simplicity has considerable merit.

Derek Allen

31 August 2013