AAT Tax Update 31 October 2014

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1. Profit extraction by dividend: make sure clients do it correctly

A number of members in practice (MIPs) have been reporting that HMRC have been challenging dividend payments. The difference between extracting profits by dividend and by earnings has considerable NIC implications so it is important that clients extracting profits by way of dividend follow the rules and do it correctly.

The financial status of the company needs to be considered each time a dividend payment is made which can prove difficult with the payment of interim dividends unless there is evidence in the form of management accounts that there were sufficient distributable profits at the time the payment was made.

These days, it is best practice to ensure there is a clear 'audit' trail. That constitutes a defence against and challenge by HMRC that an error arose from a failure to take reasonable care. Such an error would render that taxpayer liable to a penalty of up to 30% although this may be mitigated if there is a voluntary disclosure and full co-operation including telling and helping HMRC by giving access to all documents.

I recommend that when a decision is made to pay an interim dividend, a minute is prepared recording the decision and recording that the company's financial position at that time was satisfactory with sufficient distributable profits to cover the dividend. That record might become critical if within the same accounting period the business suffered a downturn and even incurred losses.

The common areas which HMRC are challenging include:

- Monthly dividends which have the possibility of HMRC arguing that the payments are salary payments.
- Dividends are ultra vires because the company lacks sufficient distributable profits
- In small family companies if dividend waivers are involved then the settlements legislation may apply (see Donovan and McLaren which is persuasive authority only).

http://www.financeandtaxtribunals.gov.uk/judgmentfiles/j7541/TC03188.pdf

2. Autumn Statement and Finance Bill 2015 developments

We have known for some time that the Autumn statement will be delivered on 3 December. The Finance Bill 2015 will have some draft clauses published on 10 December 2014. With an election in May 2015, I wonder how much of that Bill will be enacted? I worry that the Finance Bill will be voluminous and contain a lot of tax changes which are politically motivated.

3. HMRC launch a campaign for credit and debit card disclosures

On 9 October 2014, HMRC launched a new campaign to encourage voluntary disclosure of incorrect returns. The Credit Card Sales campaign provides an opportunity for individuals and companies in business that accepts payments by debit and credit card and have not reflected transactions in a return to bring their affairs up to date in a simple, straightforward way and take advantage of the best possible terms.

Some errant clients may have suppressed sales thinking that leaving the sales off the records would not be discovered. HMRC are able to access the information about transactions from the suppliers of the credit and debit cards and computers can analyse huge volumes comparing the transactions with declared sales. So the opportunity to make a voluntary disclosure might benefit:

- a business accepting payments by card that might not have declared all of their income
- a business that is trading and has not registered with HMRC and accept cards as one of their payment methods.
- a business that should have registered for VAT if it had not suppressed turnover

HMRC's guidance on the campaign is a lengthy read found at:
https://www.gov.uk/government/publications/credit-card-sales-campaign-your-guide-to-making-a-disclosure/credit-card-sales-campaign-your-guide-to-making-a-disclosure--2

4. Executors can claim negligible value relief for the deceased

In Peter L Drown & Mrs R E Leadley as Executors of Jeffrey John Leadley Deceased v Revenue & Customs [2014] UKFTT 892, the issue was whether the executors could claim relief (negligible value claims) for losses against the deceased income to be taxed before death.

The late Mr Leadley died in May 2010 in a road accident. He had invested £25,000 in a company called Datalase Ltd and another £25,000 in a company called Keronite Ltd. He also made a loan of £334,784 to Rollestone Crown Ltd. These were worthless before 5 April 2010.

In January 2011, the executors lodged a tax return claiming loss relief for £384,784 as £40,000 of the loss on the shares was set against income arising in 09/10, relying on the provisions of s 131 Income Tax Act 2000 ("ITA") which allowed a capital loss recognised under s 24 Taxation of Chargeable Gains Act 1992 ("TCGA") to be set against income. The remaining capital loss of £344,784 was originally claimed to be eligible to be carried forward against capital gains in future years.

Now let us pause here just for a minute and consider what would be fair. On death, there is a revaluation of all assets and gains are not charged to CGT. Prior to the appeal hearing the executors had accepted that the loss on the loan was not eligible for relief under s 131/s 24 so that, therefore, only part of the assessment was in dispute. The remaining issues in dispute were:

> (a) was the executors' s 131/ s 24 claim for the loss on the shares to be relieved against against income arising in 09/10 valid?
>
> (b) could the executors make a claim, relying on s 253 TCGA (*relief for loans to traders),* to carry forward against capital gains in future years the loss on the loan?

HMRC's contention was that the appellants, as executors, were incompetent to make either claim. The s 131 claim, said HMRC, could only be made by the person who owned the shares at the time they become of negligible value and the s 253 claim by the person who had made the loan. This person was Mr Leadley, who did not make the claims before he died, and obviously could not make the claims afterwards.

Frankly, in my view HMRC's contention is obviously unfair because they are seeking tax on the deceased income expecting the executors to pay tax on income which has been eliminated by losses incurred. HMRC's point is that their interpretation of s 24 is that Mr

Leadley must be alive at the time that the claim was submitted (January 2011) because s 24 presupposes he owns the asset at the time the claim is submitted.

Unfair though this may be, a strict literal interpretation of what the law states would produce this interpretation. However the tribunal ruled that the purpose of the legislation must be recognised and assists the interpretation to allow relief for the loss against the deceased income.

The executors position is that they should be treated as if they were Mr Leadley as, in submitting the 09/10 return, which entirely covered the period when Mr Leadley was still alive, they were merely representing him. So in what capacity did the executors submit the 09/10 return?

Everyone was agreed that as a matter of common law, the personal representatives of a deceased person become the owner of the deceased's assets at the moment of his death. Any income arising on those assets after that date is the liability of the personal representatives because it is their income.

It is perhaps not so obvious that the personal representatives would have any liability for tax on the income which arose *before* the death and while the assets were still owned by the deceased. Section 74 TMA puts it beyond doubt by providing:

> "s 74(1) If a person chargeable to income tax dies, the executor or administrator of the person deceased shall be liable for the tax chargeable on such deceased person……"

Looking at s62 TCGA 1992, it appears it was Parliament's intention that for future CGT purposes, the base cost for the personal representatives should be the market value at date of death and that their post-death tax liability should not be affected by gains or losses arising in the deceased's lifetime.

The tribunal ruled that the loan which had become irrecoverable did create a loss which was available to the deceased during his lifetime. For the period following his death, Mr Leadley has no tax liability so the tax benefit of the losses to which he was entitled cannot be carried forward any further. In particular, they cannot be used to offset any gains incurred by the executors during the period of their executorship.

The importance of this persuasive decision is the reliance on purposive interpretation. The decision is a fair one and it is right that executors should be able to claim reliefs to which a deceased person might have made if they had lived. It is equally fair that on death any reliefs for losses incurred stop at the death because a different legal person then takes ownership of the assets.

http://www.bailii.org/uk/cases/UKFTT/TC/2014/TC04007.html

5. Bonus clawback held to be negative earnings

Tax can be very unfair. Tax is based on statute which must be interpreted strictly. Employees are taxable on the earnings to which they are entitled. Mr Julian Martin was taxed correctly on a £250,000 bonus when he became entitled to receive it. However, his contract provided that if he left within 5 years, which he did, he had to repay £162,500. HMRC had refused to give him any relief for that payment on the argument that the expense had not been incurred in the performance of his duties but was a settlement by Mr Martin of contractual damages.

Mr Martin and another individual were existing employees of a company called JLT Risk Solutions Ltd ("**JLT**") and for some reason in late 2005 JLT must have concluded that it was important to seek to ensure that both employees were "tied in" and committed to remain employed. They thus induced both employees to enter into new employment contracts, one of the features of which was the endeavour to achieve that objective for a five-year period.

Mr Martin received a signing bonus of £250,000 but the contract obliged repayment in certain cases of termination of employment. PAYE was operated on the signing bonus so Mr Martin received £147,500 net which he declared in his 2005/2006 tax return.

In August 2006, Mr Martin gave notice of his intention to leave in 12 months' time but his employer's response was that with effect from 16 October 2006, JLT would like Mr Martin to serve the remainder of his notice period on "garden leave". Mr Martin was required to repay £162,500 which he did in three instalments within the fiscal year 2006/2007.

Mr Martin wanted to be taxed in 2005/06 on the net bonus only of £87,500 but this was rejected by HMRC and the First Tier Tribunal (FTT)+. Mr Martin was appealing that decision because he wanted to amend the earlier return and so obtain a repayment of the tax. The FTT went on to find that the payments in 2006/07 gave rise to negative earnings in that year which in turn gave rise to a right to deduct under what is now section 128 ITA. HMRC were appealing that decision.

The decision of the FTT was only persuasive authority whereas a decision of the Upper Tribunal (UT) is precedent. The issues being considered in this case are important in principle because contingent bonus payments are becoming more common and the taxation treatment of any clawback by the employer needs to be known. On 22 September, the Upper Tribunal (UT) decided to uphold the FTT judgment in the case of *HMRC v Julian Martin* [2014] UKUT 429 (TCC).

The UT confirmed its agreement with the FTT's view that the payment of £162,500 by Mr Martin to JLT should count as "negative earnings", as it had the characteristic of earnings, albeit paid in the "wrong" direction, because it was a payment arising from the contract of employment. So in the year when paid, Mr Martin was able to deduct the outgoing for tax purposes.

Mr Justice Warren gave a very detailed analysis of the interaction of clauses 2.2 and 4.4 to justify his conclusion that the sums paid by Mr Martin were negative earnings and qualified for relief under s128 ITA. His decision will be important if bonus payments are contingent and repayable on some future event so it is important to appreciate that contracts of employment should be drafted after taking expert legal advice on the potential tax position.

http://www.bailii.org/uk/cases/UKUT/TCC/2014/429.html

6. Increase in the amount of debt recovered by coding restriction for high earners

Advance notice for Agents - Increases to the amounts collected by PAYE Tax code
HMRC are changing the coding out limits to increase the amount of debt collected through a Tax code. It only affects those earning £30,000 p.a. or more.

Coded out debts with the new limits applied will be included in your client's Annual Coding Notice (P2) for 2015-16 and the first deductions from income will start in April 2015.

7. HMRC publish agent Update 44

Agent Update 44 (PDF 458K)
On 21 October, HMRC published the bi-monthly round up of the latest developments in tax, HMRC service and consultations for accountants and tax professionals. It contains a section on the latest news and issues from the Working Together network.

Derek Allen
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Set your diaries for the next edition of the general tax update which will be published around 30 November 2014

The views expressed in these podcasts are Derek Allen's personal views and do not necessarily represent AAT policy or strategy.