Tax update

June 2016

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GAAR penalties

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Deal Struck with British overseas territories and Crown dependencies

After protracted negotiations, the UK has now reached agreement with the BOTs and Crown Dependencies to enable the prompt sharing of information in relation to the beneficial ownership of corporate and legal entities incorporated in those jurisdictions. more›

New HMRC manual on exchange of information

HMRC has published its new "International Exchange of Information Manual". more›

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Tribunal considers carelessness test and finds discovery assessments to be invalid

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Tribunal finds that deferred shares are ordinary shares for the purposes of entrepreneurs' relief

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Any comments or queries?

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About this update

The Tax update is published on the first Thursday of every month, and is written by members of RPC's Tax Dispute team.

We also publish a VAT update on the final Thursday of every month, and a weekly blog, RPC Tax Take.

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News

GAAR penalties

The Finance Bill 2016 contains provisions which will introduce a specific penalty linked to the General Anti-Abuse Rule (GAAR) provisions. The penalty will be 60% of the value of the counteracted advantage if HMRC successfully challenges the tax arrangements under the GAAR. Additionally, HMRC will have the power to issue provisional counteraction notices and binding and generic referral notices to the GAAR advisory panel.

The absence of any right for the taxpayer to make representations to the GAAR panel is likely to make the use of these powers highly controversial and potentially lead to more public law challenges.

The Finance Bill 2016 is available to view here.

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Deal struck with British overseas territories and Crown dependencies

After protracted negotiations, the UK has now reached agreement with the BOTs and Crown Dependencies to enable the prompt sharing of information in relation to the beneficial ownership of corporate and legal entities incorporated in those jurisdictions.

The relevant agreements are available to view here.

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New HMRC manual on exchange of information

HMRC has published its new International Exchange of Information Manual. This provides information and guidance on the automatic exchange of information under:

- the OECD's common reporting standard
- EU Council Directive 2014/107/EU
- Financial Accounts Tax Compliance Act
- UK's arrangements with the Crown dependencies and overseas territories (reported above).

It is anticipated that the manual will be expanded in due course.

The manual is available to view here.

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Case reports

Tribunal allows taxpayer's appeal following poor customer service by HMRC

In *Usher & Perkins, Executors of Terence J Guy (deceased) v HMRC* [2016] UKFTT 050 (TC), the First-tier Tribunal (FTT), allowed the executors' appeal against a penalty.

Background

The taxpayer died on 15 October 2012. The estate was estimated to be valued at some £1.5million. An inheritance tax return was filed in January 2013 and probate applied for in February 2013.

On 10 August 2013, the executors filed the taxpayer's self-assessment return for 2012/2013, which under-declared the taxpayer's income for the period from 6 April 2012 to the date of death.

On 26 September 2013, one of the executors wrote to HMRC enclosing a cheque for £15,332.92, representing what they believed to be the outstanding income tax due. The letter stated that "I will have to presume that this is in full and final settlement, as I am now proceeding to finalise and distribute the estate".

The executors proceeded to distribute the estate but failed to publish the statutory notice in the London Gazette notifying potential creditors that they intended to distribute the estate. This would have given creditors a period of two months in which to lodge any claim.

In September 2014, HMRC queried whether there had been an under declaration of the deceased's income in the 2012/13 return. HMRC issued a discovery assessment under section 29, 1970.

In addition to the assessment, HMRC issued a penalty of £5,060.18 for failure to disclose income, under Schedule 27, Finance Act 2007 (FA 2007), for conduct that was "deliberate but not concealed".

The executors accepted that their conduct had been careless since the figures in the self-assessment tax return did not match those in the inheritance tax return they had filed, which had contained the correct figure for the deceased's investment income, but they did not accept that their conduct had been deliberate. The executors felt aggrieved that HMRC had taken a year to raise its query and after it had been given explicit notice that the estate was to be distributed. Although HMRC admitted poor customer service, it maintained the penalty.

The executors appealed to the FTT.

FTT's decision

The executors argued that they had no reason to attempt to evade the relatively small amount of tax in issue. The error made in the return had been a genuine error and the correct amount of income tax could have been paid had HMRC simply asked for it in good time following the executor's letter of 26 September 2013. HMRC's delay in responding to the letter was the cause of the predicament in which the executors now found themselves: (they had distributed all the estate and had no legal right of reimbursement against the beneficiaries).

The executors accepted that their error had been "careless" but it was not reckless or with intent to cause loss to HMRC. They accepted that the tax was lawfully due, but argued that due to the mistake being genuine and unintentional, a penalty should not have been levied against them.

The FTT agreed and commented that under paragraph 11, Schedule 24, FA 2007, HMRC could have reduced the penalty "because of special circumstances". HMRC's admitted delays in dealing with the case (including poor and untimely customer service), warranted "some consideration of special circumstances". Had HMRC's delays not occurred, it "might well have spared [the executors] the difficulty they are in now". Accordingly, the appeal was allowed.

Comment

The FTT pointed out that it did not have jurisdiction to deal with matters of maladministration on the part of HMRC, but it was clearly influenced by HMRC's delay in dealing with the case and considered this partly the reason for the executors' difficulties and it therefore reduced the penalty to nil.

This case is also a useful reminder of the protection afforded by section 27, Trustee Act 1925. Section 27 enables trustees or personal representatives to protect themselves from liability against any claims from creditors and/or beneficiaries that they have not had any notice of at the time that they convey or distribute the property in question, provided that the notice placed complies with the requirements of that section. This includes, among other things, advertising the intention to convey or distribute the property through a notice placed in the London Gazette. Though it is not a legal requirement, any trustee or personal representative placing a notice in accordance with section 27 will not be liable to any such creditors or beneficiaries.

The decision is available to view here.

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Tribunal considers carelessness test and finds discovery assessments to be invalid

In *Bubb v HMRC* [2016] UKFTT 0216 (TC), the FTT allowed the taxpayer's appeals and concluded that two discovery assessments made by HMRC under section 29, TMA 1970, were not validly made because only part of the tax underpayment resulted from the taxpayer's carelessness.

Background

The taxpayer served over 28 years in the navy followed by 15 years in the civil service. He had been in receipt of both a naval and civil service pension since 1989 and 2003, respectively, and a State pension from 2009.

After leaving the civil service, the taxpayer was engaged from time to time as a consultant, working for the Ministry of Defence. In order to avoid the difficulties he had witnessed other consultants fall into with unexpected tax bills, the taxpayer wished to continue to be paid under the PAYE system. Accordingly, during the relevant periods in question, he was employed by a firm called Parasol, who charged the Ministry of Defence for the taxpayer's services and then paid him via PAYE. However, in error, Parasol operated the standard emergency tax code allocating full personal allowances to the taxpayer. As full allowances had already been allocated to his civil service pension, the code Parasol should have operated for a secondary source of income was the "BR" code, which was the code used for the taxpayer's naval pension. Despite Parasol notifying HMRC that the taxpayer's earnings from his employment with Parasol were a secondary source of income, no tax code was issued by HMRC and Parasol continued to use the emergency code.

Following receipt of notices from HMRC to file returns in relation to tax years 2008–2011, the taxpayer correctly completed his 2008/09 return, showing an underpayment of tax. Although he completed returns for 2009/10 and 2010/11, these returns contained the following errors:

- both returns omitted details of the State pension. The pension was paid into his wife's account and he had forgotten to include it. For 2010/11, HMRC's system identified this oversight and corrected his return, but the system in place for 2009/10 did not
- the 2009/10 return understated the total for occupational pensions
- the 2010/11 return understated earnings from Parasol and overstated tax deducted.

The errors in the returns, combined with the fact that HMRC's system did not pick up the significance of the entries in the "additional information" box in the returns, meant that instead of the underpayments for each year being identified and addressed, HMRC's system generated tax repayments for each year.

In May 2013, HMRC issued discovery assessments to the taxpayer pursuant to section 29, TMA 1970, in order to make good the under assessments resulting from the errors referred to in (2) and (3) above. HMRC also issued surcharges under section 59C(2) and (3), TMA 1970, in relation to the late payment of income tax in respect of 2008/2009.

The taxpayer appealed the discovery assessments and surcharges.

FTT's decision
In allowing the appeals, the FTT considered whether the requirements of section 29(1), TMA 1970, had been met in relation to 2009/10 and 2010/11 and if so, whether the condition in section 29(4), TMA 1970, had been satisfied.

The FTT concluded that the requirements of section 29(1) were met in relation to both 2009/10 and 2010/11, stating that "HMRC clearly 'discovered' that there was income that had not been assessed for both years in or shortly before April 2013". The FTT commented that section 29(1) is concerned with the inspector's subjective view and does not require any new facts to emerge (*Hankinson v HMRC* [2012] STC 485 and *Charlton v HMRC* [2013] STC 866 applied).

In order for HMRC to succeed in its argument that the assessments were validly made under section 29, it had to demonstrate (the onus of proof being on it) that it was the taxpayer's careless behaviour which brought about the under assessment of tax in respect of 2009/10 and 2010/11, as required by section 29(4).

Whether the taxpayer was careless was a question of fact, to be determined by the FTT having regard to all the circumstances.

Having considered the available evidence, the FTT concluded that the taxpayer was careless in not including his State pension in either his 2009/10 or 2010/11 tax returns, noting that by simply overlooking it on the basis that it was paid into his wife's account was "clearly careless".

However, the FTT was of the view that the taxpayer had not been careless in relation to the errors contained in his tax returns for 2009/10 and 2010/11, referred to at (2) and (3) above, due to the IT difficulties he had experienced when submitting his tax returns. In addition, the FTT did not consider the taxpayer's use of his last payslip, rather than a more accurate P60, to be careless because a clear disclosure in this regard was made by the taxpayer to HMRC when submitting his tax returns. In particular, the FTT commented that the taxpayer would have no reason to be aware that HMRC's normal processing systems do not pick up details included in the additional information box, and he would also reasonably have assumed that HMRC had received P60 information from Parasol.

The FTT therefore concluded that as there is no power to raise a valid assessment to make good a loss of tax that is not attributable to careless behaviour, the discovery assessments had not been validly made by HMRC under section 29, TMA 1970.

HMRC had also submitted that the FTT should increase the assessment for 2009/10 under section 50(7), TMA 1970, in order to rectify the fact the taxpayer had failed to include details of his State pension in his 2009/10 return. In relation to this submission, the FTT concluded that as section 29 goes to the validity of the assessment, if no assessment is validly raised, then there is nothing that can be increased.

In relation to the surcharges issued by HMRC under section 59C(2) and (3), TMA 1970, for the late payment of income tax in respect of 2008/2009, HMRC confirmed at the hearing that it would no longer be pursuing payment of the surcharges. It was therefore unnecessary for the FTT to consider whether the taxpayer had a reasonable excuse for not paying the tax due in respect of 2008/09.

Comment

Although the taxpayer had been careless in omitting details of his State pension when submitting his tax returns, the discovery assessments issued by HMRC were to make good under assessments resulting from other errors the taxpayer had made when submitting his returns, none of which were as a result of careless behaviour on his part.

HMRC regularly invokes its section 29 information powers and this decision is a timely reminder that when it does so, it needs to ensure that the conditions referred to in section 29 are fulfilled. In this instance, it failed to satisfy the FTT that the taxpayer's careless behaviour led to the under assessment of tax.

It is also worth noting the FTT's criticisms of the way in which HMRC dealt with the taxpayer's affairs, which resulted in HMRC accepting that the taxpayer deserved a better service from HMRC than the one he had received.

The decision is available to view here.

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Tribunal finds that deferred shares are ordinary shares for the purposes of entrepreneurs' relief

In *Alan Castledine v HMRC* [2016] UKFTT 145 (TC), the FTT dismissed the taxpayer's appeal and found that deferred shares qualified as ordinary shares for the purposes of entrepreneurs' relief.

Background

The taxpayer claimed entrepreneurs' relief for the years 2011/12 and 2012/13, in respect of the disposal of loan notes in Dome Holding Limited (DHL). The only issue between the parties was whether the test for eligibility for such relief in section 169S, Taxation of Chargeable Gains Act 1992 (TCGA) (at least 5% of the ordinary share capital held by the individual), had been satisfied.

The issued share capital of DHL at the relevant time included both ordinary shares and deferred shares.

If the deferred shares were counted as ordinary shares, the taxpayer would hold 4.99% of the ordinary share capital of DHL and would not qualify for entrepreneurs' relief. However, if the deferred shares were excluded, the taxpayer would hold 5% of the company's share capital and would qualify for entrepreneurs' relief.

On 29 July 2011 and 31 July 2012, the taxpayer disposed of his loan notes for £600,303 and £505,009, respectively. This gave rise to chargeable gains. The taxpayer's claim for entrepreneurs' relied was rejected and he appealed to the FTT.

FTT's decision

Under DHL's articles of association, the deferred shares had neither voting rights nor rights to dividends. They could only be redeemed at par on capital realisation after at least £1 million had been distributed in respect of each ordinary B share. As there were at the relevant time 2,001,985 B shares in issue, the taxpayer argued that the deferred shares had in reality no rights.

The FTT noted that the class of deferred shares was created for commercial reasons. It was a way of removing the ordinary B shares from senior management of DHL when they left the company and taking away any influence they might otherwise have over the running of the company. Under DHL's articles, ordinary B shares are automatically converted into deferred shares in the case of certain "conversion events", including the holder leaving the employment of the company.

The taxpayer submitted that Parliament did not intend to categorise as ordinary shares holdings which had none of the characteristics of an ordinary share. The FTT was referred to the definition of "shares" contained in section 540, Companies Act 2006, which provides that share means a "share in the company's capital". This implies that there must be a quantifiable sum of money related to each share which entitles the holder to certain rights. In this case, the deferred shares deliberately did not entitle the holder to any rights and were shares in name only.

HMRC argued that the legislation was unambiguous and clear. The legislation defined an easily applied dividing line giving rise to no uncertainty. Accordingly, there was no need and no justification for the FTT to go beyond the plain words of the statute.

The FTT concluded that the intention of Parliament was to give the term "ordinary share capital" a wide interpretation. This was clear from the broad definition provided in section 989, Income Tax Act 2007 (ITA), by the words in parenthesis "however described".

Whilst acknowledging that the arguments were finely balanced, the FTT felt it was unable to depart from the plain language of the legislation under consideration and concluded that the deferred shares fell within the meaning of "ordinary share capital" in section 989, ITA. The appeal was therefore dismissed.

Comment

The taxpayer will no doubt be very disappointed by this decision. As a result of the interpretation of the legislation preferred by the FTT, he failed to qualify for entrepreneurs' relief due to holding 0.01% too little of the company's share capital.

It is also interesting to note that in this instance, HMRC was content to argue that there was no need for the FTT to go beyond the plain wording in the statute. Of course, when taxpayers argue that the plain wording of a statute should be followed, HMRC often contends that a purposive approach to statutory construction should be adopted. A degree of consistency from HMRC in this regard would be welcome.

The decision is available to view here.

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