Field Court Tax Chambers

FCTC Digest

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EDITORIAL

Katherine Bullock

Welcome to the eleventh edition of the FCTC Digest. This edition is packed full of tips, traps and practical insights to share with our readers.

In the first article, **Patrick Soares** has identified the 2 year rule and the "house maintenance trap" as the practical problem areas for tax practitioners engaging with the new Inheritance Tax rules surrounding the holding of UK residential property through an offshore company. This article is full of diagrams and helpful examples to illuminate this tricky and fast developing area. Practitioners are going to want to study this very carefully indeed: see *Offshore companies holding UK dwellings: The see-through for Inheritance Tax (IHT) purposes – Don't get caught out by "the two year trap" or "the house maintenance trap"!*

We have two articles this month from **Patrick Way QC**. The article *Image Rights – Where are they located, in the UK or abroad?* considers HMRC's recent and so far unjustified argument that the source of image rights income can be ascertained by applying trading principles. This is an area which is bound to engage tax practitioners and HMRC well into 2023. You will get the inside track here!

In his second article, *Advocate's Corner,* ***Patrick Way QC*** discusses three non-tax cases which raise important issues for all readers. The first exposes the ethical dilemma of commenting on a case before it has concluded its final appeal. The second concerns the ability of third parties to seek judicial review in cases where they have no direct interest. The last concerns the disturbing case of bullying one's opponent in Court. Let us hope this brings to an end overly aggressive and antagonistic tactics which have no place in Court.

Expenses in employment - A new dawn? by **Peter Vaines** takes a look at the recent and wholly unexpected decision in *Kunjur v HMRC TC 8296.* Does this represent a modern interpretation of the tax treatment of expenses in employment? What does this mean for countless other taxpayers whose expenditure has not been allowed or have been advised not to claim such expenses? Read on to find out more.

My own article deals with yet another question that has recently crossed my desk on the tax treatment of loans to family investment companies. Is there an argument that an interest bearing loan might be a gift with reservation of benefit? As with so many questions surrounding FICs, the tax analysis is never straightforward. See *Damned if you do and damned if you don't: FICs, Loans and Gifts with Reservation* by **Katherine Bullock.**

This edition ends with an insightful answer to an intriguing question: Should the UK Government lower VAT rates following BREXIT? This is a question of increasing practical and commercial importance as well as of academic interest. You will find an answer from **Dilpreet Dhanoa** in her article *BREXIT: the big indirect break?* It seems appropriate, therefore, to leave this editorial with the sobering thought that starts Ms. Dhanoa's article:

"When a new source of taxation is found it never means, in practice, that the old source is abandoned.

It merely means that the politicians have two ways of milking the taxpayer where they had one before."[1]

Happy reading!

[1] H. L. Mencken (early 20th century).

OFFSHORE COMPANIES HOLDING UK DWELLINGS

THE SEE-THROUGH FOR INHERITANCE TAX (IHT) PURPOSES – DON'T GET CAUGHT OUT BY "THE TWO-YEAR TRAP" OR "THE HOUSE MAINTENANCE TRAP"!

Patrick C Soares

Introduction

Since 6 April 2017 the IHT legislation applies a look-through approach where overseas companies own interests (directly or indirectly) in UK dwellings.

The legislation is in F2A Sch 10 which puts a new schedule into IHTA 1984.

From 6 April 2017 for *inheritance tax purposes only* shares and interests in foreign close companies (IHTA 1984 Sch A1 para 9) ceased to be excluded property to the extent that the value of the shares and interests is derived, directly or indirectly, from residential property in the UK.

These provisions have no relevance to non-residential property.

The charge situations include:

- the death of the individual wherever resident who owns the company shares
- a gift of the company shares into a settlement
- the 10-year anniversary of the settlement
- distribution of the company shares out of the settlement
- the death of the donor within 7 years of having given the company that holds the UK property away to an individual
- the death of the donor or settlor where he benefits from the UK property held by the company or shares within 7 years prior to his death – the reservation of benefit rules will apply to the shares of a company owning UK property in the same way as the rules currently apply to UK property held by foreign domiciliaries and generally to UK domiciliaries.

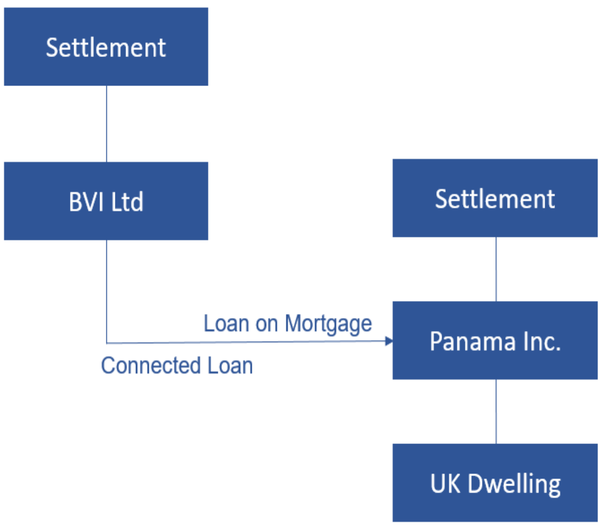
The legislation in detail

The legislation takes away the excluded property status of foreign close company shareholdings and creditor loan rights to the extent that the value of the rights or interests are attributable to a UK residential property interest (Sch A1 para 2).

The legislation also covers shares held by a foreign company which owns shares in a UK company which owns the dwelling (Sch A1 Para 2(2)(b)(i)).

It will also cover loans from one foreign company to another where the money is used to buy a UK residence.

Example - loan to company from a company

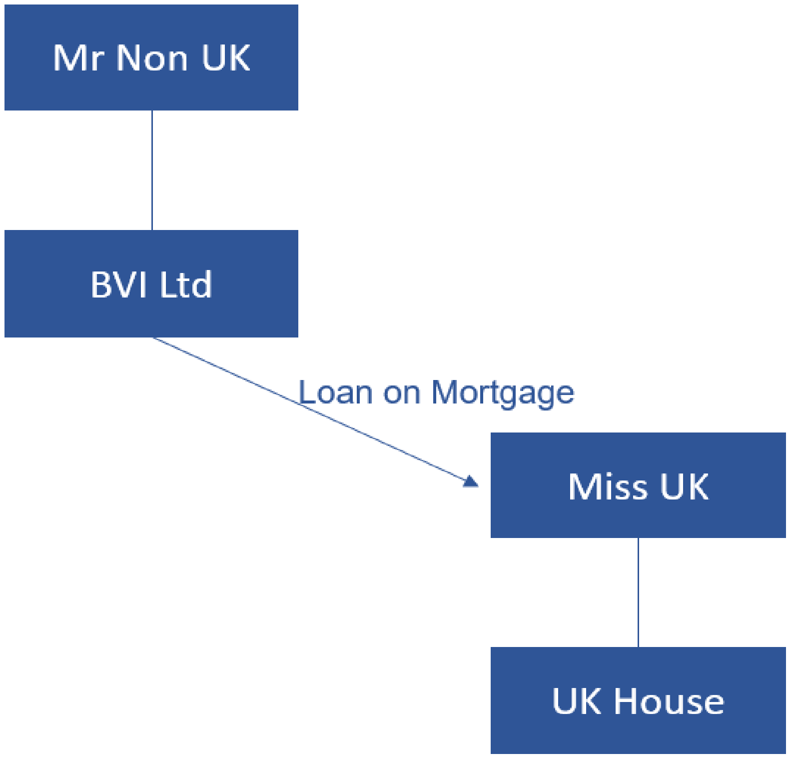


In the *above* example the loan was made to the company (Panama Inc) to buy the residence (and not to an individual, partnership or the trustees of a settlement) and it is thus not a "relevant loan" (see below). The shares in BVI Ltd however suffer a see-through because of the rights and interests which BVI Ltd has in Panama Inc. That is the case even though the loan may not be on mortgage.

The loan in the example *below* is a "relevant loan" within Sch A1 paras 3 (assuming it was taken out to buy the UK house) and a see-through of the shares in BVI Ltd occurs by virtue of Sch A1 para

2(2)(b)(iii). The fact the loan is no mortgage is irrelevant.

Loans to individuals are caught and are known as "relevant loans"



Example (Shares in a UK Company)

BVI Inc owns a UK company which owns a UK dwelling. The shares in BVI Inc are not excluded property under the new regime.

Ambit of see-through

This see-through is not just restricted to shareholdings. It applies to the rights and interests of participators (Schedule A1 para 2(1) and para 9(1)).

A participator includes a loan creditor (Schedule A1 para 9 and CTA 2010 ss 453 and 454) and the reference to rights and interests include the rights and interests in the assets of the company available for distribution in the event of the winding-up of the company or in any other circumstances (Sch A1 para 9(2)).

The legislation applies if the rights and interests in the close company derive their value from the direct ownership of the dwelling or from the indirect ownership of the dwelling (Sch A1 para 2(2)).

This means that if Mr Z has rights or interests (e.g. shares and loans) in foreign close company A and foreign close company A has rights and interests (e.g. loan creditor rights) in foreign close company B and foreign close company B owns a UK dwelling, on the death (say) of Mr Z, IHT is in issue.

IHT would still be in issue even if a subsidiary of B held the dwelling.

<u>Example</u>

BVI Inc owns a UK dwelling worth £5m. Mr Z (a non-UK resident and non-UK-dom (NRND)) lent

Cayman Inc (Mr Z owns all the shares in Cayman Inc) £4m which onward lent the same (interest free repayable on demand) to BVI Inc to buy the dwelling. Mr W (also a NRND) owns all the shares in BVI Inc. On the death of W after 5/4/17 IHT is payable on £1m (if the property goes up in value this charge is increased) (see Sch A1 para 2(2)(a), "directly") and on the death of Z after 5/4/17 IHT is payable on £4m (see Sch A1 para 2(2)(b), "attributable").

Note there is a modest de minimis: if the value of the interest in the close company is less than 5% of the total value of all the interests in the close company (see Sch A1 para 2(3) and (4)) the charge does not apply.

<u>Special Relevant Loans Provisions</u>

Shares in a foreign company are not treated as excluded property to the extent the company owns relevant loans (Sch A1 para 2(2)(b)(iii)).

Paras 3 and 4 of Sch A1 IHTA 1984 defines a "relevant loan".

A loan is a relevant loan if and to the extent that money or money's worth, made available under the loan, is used to finance, directly or indirectly the acquisition **by an individual, a partnership or the trustees of a settlement** of a UK residential property interest.

References to the acquisition of a UK residential property interest by an individual, a partnership and the trustees of a settlement include **the maintenance, or an enhancement, of the value** of a UK residential property. It is easy to overlook this and is a **tax trap**.

Where the UK residential property interest by virtue of which a loan is a relevant loan is disposed of, the loan ceases to be a relevant loan.

Where a proportion of the UK residential property interest by virtue of which a loan is a relevant loan is disposed of, the loan ceases to be a relevant loan by the same proportion.

References to a loan include an acknowledgment of debt by a person or any other arrangement under which a debt arises; and in such a case reference to money or money's worth made available under the loan are to the amount of the debt.

Thus money raised under a deeply discounted security will be within this legislation.

<u>Comments on the relevant loan provisions</u>

These provisions do not disallow debts as deductible IHT liabilities even from connected parties.

Note debts can be relevant loans if the borrowed monies were used to acquire the UK residential property or rights or interests in close companies which own UK residential property (Sch A1 para 4(1)(a)).

The "relevant loan" provisions in Sch A1 para 3 which cause a see-through of the foreign company shares do not cover a loan to a company (one must look to Sch 1A para 2 to cover those situations).

<u>Example</u>

Mr X is not resident in the UK and not domiciled in the UK. His Bermuda family company which he owns lends money on mortgage interest free repayable on demand (£10m) to his daughter in the UK to buy a house. When Mr X dies he is liable to IHT at up to 40% on the shares to the extent they reflect the value of the loan (Sch A1 para 2(2)(b)(iii)). Note if Mr X had lent direct to his daughter the result would be the same even if the debt to buy the UK residential property was secured on non-UK assets and made under seal governed by Bermuda law and the deed was physically located overseas on the death of Mr X (see Sch A1 para 4(1)(a)). When the daughter dies she pays IHT on the house minus the debt (under general principles this needs to be repaid on death for there to be a tax (IHT) deduction: IHTA 1984 s175A).

The effect of the new legislation is loans to companies are not relevant loans as such within Sch A1 para 3 but they are still caught by the new legislation as comprising rights and interests in a close company within Sch A1 para 2(1) and para 9.

Example

Y owns BVI Inc which own a UK dwelling as an investment. Y is the daughter of X. X lent BVI Inc the monies to buy the property. Unless special provisions are introduced to disallow the loans as deductions the loan will be deductible for IHT purposes. The new Sch A1 para 3 would not cause a problem as the paragraph does not apply to loans to companies. However, Shed A1 para 2(2)(b) treats X as having a right or interest in BVI Inc which is attributable to UK residential property and thus on the death of X for example IHT is in point (Sch A1 paras 1 and 2).

Loans to buy shares

The Finance Bill 2017 did not provide that a loan taken out by the taxpayer (P) to buy shares in a company which owned residential property was a relevant loan. However, F2A did contain such a provision (IHTA 984 Sch A1 para 4(1)(a)(ii) contains the relevant legislation).

Example

The trustees of the X Jersey settlement borrow £1m from BVI Inc to fund the purchase of the shares in J Limited (a company which owns a UK dwelling). The loan is a relevant loan.

Partnerships

Note special rules apply where taxpayers hold an interest in a partnership which owns UK residential land. They may argue under general principles the partnership rights are a separate chose in action and may have a foreign location. Sch A1 para 2(1) ensures this argument – which is a tenuous one in any event – is no longer sustainable after 5/4/17.

Provisions Restricted to Dwellings – What is a dwelling?

Dwelling is to have the same definition as in the new CGT code which applies to non-residents who sell UK dwellings after 5/4/15 – the NRCGT code (see TCGA 1992 Sch B1).

This covers buildings used or suitable for use as dwellings and buildings in the course of being constructed as dwellings or adapted for use as dwellings and the grounds in which such buildings are situated. Care and nursing homes will not be dwellings.

Disposals and repayments – the 2-year rule

Note there is an anti-avoidance provision in Sch A1 para 5.

If the taxpayer rids of the property which is treated as located in the UK under these provisions – the taxpayer for example sells the shares in the close company which owns the UK residential property or a relevant debt is repaid or the shares in a close company which owns the relevant debt are sold – there is a two year period where the proceeds are not treated as excluded property.

Example (shares in company held direct)

Mr Non-dom owns shares in BVI Inc which owns UK residential property. From 6/4/17 the shares will have ceased to be excluded property (new Sch A1 para 2(1)). He sells the shares after 5/4/17. The proceeds of sale are not excluded property for 2 years (Sch A1 para 5(1)(a) and para 5(2)(a)). The residential property instead is sold and the proceeds are in a UK bank account of the company. Mr Non-dom holds excluded property and the 2-year period is irrelevant (SchA1 para 5(1) has no application). The company is liquidated (after the property has been sold) and the proceeds are put in a foreign bank account. The property is excluded property and the 2-year period is irrelevant (Sch A1 para 5(1) is not engaged). If the company is liquidated before the house is sold and the house vested in Mr Non-dom the house is the consideration for the disposal of the shares (it is arguable: in other contexts HMRC take that view: see IHTM28015): in that case the 2 year period applies even if the house is sold within the 2 years and the proceeds are put in a foreign bank account (Sch 13 para 5(1)(c)).

Example (settled property)

If the shares in a foreign company (holding a dwelling) held in a settlement are sold and the settlor was a non-dom the sale proceeds (even though reinvested in non-UK located assets) for 2 years from the sale are not excluded property (IHTA 1984 s48(3)(a) and Sch A1 para 5(2)(a)). Thus, if a 10-year anniversary charge is to be avoided the shares must be sold more than 2 years earlier. The sale of the shares themselves will not give rise to an exit charge; the shares are non-excluded property and the proceeds wherever situated are deemed to be non-excluded property (Sch A1 para 5(2)(a): IHTA 1984 s65(7) is not engaged). Also, there is no exit charge on the expiry of the 2-year period when the proceeds revert to being excluded property. Also, if the underlying property is sold by the company the trust property (the shares in the company) ceases to be within Sch A1 para 2 and thus reverts to being excluded property: s65(7B) ensures no exit charge will arise in that event. Also, note if the trust owns a UK dwelling direct throughout its period of ownership the 2-year period is irrelevant.

<u>Example (Sale by trustees within 2 years from 10-year anniversary)</u>

Mr Non-dom put shares of A Inc (which owns a UK dwelling) into a settlement on 1 April 2017. That is an excluded property transfer (as it was made before 6 April 2017. A year before the 10-year anniversary on 1 April 2027 the shares are sold and the proceed held on trust in a foreign bank account. Throughout virtually the entire 10 years the settlement has held non-excluded property (IHTA 1984 Sch A1 paras 1 and 2(2)(a)) and a 10 anniversary charge is payable. In year 11 the proceeds become excluded property (IHTA 1984 Sch A1 para 5 (1)(a), (2)(a) and (3)(a)) but no exit charge will arise (IHTA 1984 s65(7C) and F2A Sch 10 para 5).

Example (loan to daughter)

Mr X has no UK connections and he lent £5m to his daughter to buy a UK house. If Mr X dies he pays IHT on the loan (IHTA 1984 Sch A1 para3 (a)). If he gives the loan to his daughter it will be a PET and he will need to survive the 7-year period. If she discharges the loan he need only survive 2 years (IHTA 1984 Sch A1 para 5(1)(b) and (3)(b)).

Conclusions

These provisions can apply in many different circumstances but the contributor has found that the 2-year rule and the "house maintenance trap" are the main problem areas in practice.

IMAGE RIGHTS – WHERE ARE THEY LOCATED, IN THE UK OR ABROAD?

Patrick Way QC

Speed read

A non-domiciled UK-resident sports person – typically a footballer – will benefit if their image rights are located – as a matter of legal analysis – outside the United Kingdom. This is because the remittance basis will apply to the royalty payments because they will be representative of foreign source income. HMRC have recently begun an argument across the board to the effect that the source of image rights income can be ascertained by applying trading principles. On this basis HMRC argue that most image rights income is UK source. On no occasion do HMRC give a justification for this stance and in the writer's view HMRC's current approach should be resisted.

The source of image rights

One of the privileges of being a barrister (and the benefits) is that one sees the same question across one's desk on more than one occasion. In the world of image rights we are, of course, aware, that HMRC typically try and run the transfer of assets abroad argument where the footballer is non-domiciled. I will return to this point shortly. HMRC have also run and abandoned arguments on the basis that image rights' income is subject to the transfer of income stream rules; or is subject to the sales of occupation income rules; or the transfer pricing rules apply; and, HMRC have even argued until not that long ago that image rights did not exist at all.

The new stance which they are running, however, is that in effect one ascertains the source of image rights by applying the same principles as one would apply when seeking to ascertain see whether a individual was trading. This argument is put forward by HMRC, so far as I can see, without authority. In the *Sports Club* case (*Sports Club v HM Inspector of Taxes* (SpC, [2000] SSCD 430 (SpC 253)) it is interesting to note that the Inland Revenue (as they then were) sought to argue that the income which the two well-known Arsenal players had received was effectively employment income or failing that a benefit in kind. That argument was lost before the Special Commissioners: the income was neither employment income nor representative of a benefit in kind. It seems to me that the same analysis would apply to any argument that trading principles apply to image rights' income.

My own view is that the relevant test to apply is the multifactorial and practical/commercial test which is found in the case of *Ardmore* (*Ardmore Construction Limited v HMRC* CA, [2018] EWCA 1438).

In the *Ardmore* case the Court of Appeal were asked to ascertain the source of interest: again was it within the United Kingdom or outside the United Kingdom? The Court of Appeal agreed with the House of Lords in the earlier *Bank of Greece* case (*Westminster Bank Executor & Trustee Co (Channel Islands) Limited v National Bank of Greece SA* HL 1970, 46 TC 472) that the correct approach was multifactorial. This meant that one looked at the situation by weighing up all the relevant factors and then deciding on balance – by reference to those factors – whether the source was in the United Kingdom or abroad. In carrying out this weighing up process, however, the Court had to be practical and commercial. In other words, the test was not to look at the situation through blinkers. By this I mean that if a series of documents have been produced to cosmetically "push" the source in one direction when on a practical/commercial basis the source would be found in another direction, then the Court must take a practical and commercial view. It seems to me that this same approach should be applied when ascertaining the source of the image rights' income. In other words, the test should be multifactorial and should be applied on a practical and commercial basis.

Finally, it is worth noting that the test is to the source of the income from the image rights, not the image rights themselves. There can often be a difference.

This is an area which I am sure will develop over the next twelve months or so and it will be interesting to see how it turns out. My view remains, however, that the trading test is inappropriate to apply in relation to image rights' income.

ADVOCATE'S CORNER

Patrick Way QC

Speed read

- *Why a barrister should not go public in connection with a case with which they are involved*
- *Locus standi*
- *Bullying*

Advocate's corner

Three cases

Three high-profile cases have caught my eye recently although none of them is a tax case. They are relevant nevertheless.

Don't go public

In one case a barrister, halfway through a very high-profile case, made a public statement about how their opponents and the arguments put forward by their opponents were wholly unacceptable in the 21st Century. This had me thinking: why should you not do this? My own view is that one should not comment on a case until it is completely finished, i.e. one has reached the final appeal. But in any event it seems to me just to be “bad form” and I was therefore interested to see in the Ethics Guide for Barristers that the position is covered where one expresses a personal opinion: one should not do it. The reason for this is that by expressing an opinion, so the objection goes, one undermines the barrister’s obligation under the so-called “cab rank rule”. In other words, if one gives a particular view then that is likely to deter clients or types of clients from instructing you in the future if potential clients consider that your own view is alien to theirs.

However, quite apart from the ethical point of view, my own position is that it is “bad manners” to mouth off against an opponent’s view publicly.

Locus standi

In another high-profile case the High Court ruled on the ability of third parties to bring judicial reviews in relation to cases where they have no direct interest. The High Court stated that it cannot be the case that particular bodies have carte blanche to bring any claim for judicial review no matter what the circumstances. This struck a chord with me because many years ago I was instructed on a judicial review case (*R v. Inland Revenue Commissioners ex parte Continental Shipping* [1996] STC 813).

This involved an information notice under what was then TMA 1970 s.20(8E)(b) and (8G)(g). For various reasons the applicants preferred to make the application in the name of their company rather than themselves and it was undoubtedly the case that the lack of *locus standi* (although not the absolute reason for the decision) played a part in the High Court finding that there had been no breach in the relevant formalities for producing a valid information notice. Accordingly, the judicial review application failed.

Bullying

Finally, in another high-profile case, a barrister has been reprimanded for their bullying behaviour towards another barrister in court.

This again struck a chord with me since at the end of a hearing, last year, in which I was involved, a tribunal judge thanked all the parties for the convivial and pleasant way in which the proceedings had been conducted. He went on to say that these days hearings before him were often very aggressive and antagonistic. This, to say the least, is unfortunate and I very much hope that it is a practice that will come to an end soon.

EXPENSES IN EMPLOYMENT

A NEW DAWN?

Peter Vaines

The rules relating to the deduction of expenses from employment income are almost too well known to be worth repetition. They have been around forever – the latest incarnation being in section 336 ITEPA 2003. This sets out the general rule that a deduction from earnings is allowed for an expense if:

a) The employee is obliged to incur and pay it as a holder of the employment and,

b) The amount is incurred wholly, exclusively and necessarily in the performance of the duties of the employment".

The first part of the test is that the employee must be obliged to incur and pay the amount as a holder of the employment. That is a very strict test. It must be necessary by reason of the employment, and not merely necessary for the particular employee, for the expenditure to be incurred and paid. So every employee must be obliged to incur the expenditure to do his job, for this element to be satisfied. That is obviously very difficult – but even if you can satisfy this test, it is still not enough, because you also need to satisfy the second condition.

The second condition is equally demanding. The expenditure must be incurred wholly, exclusively and necessarily in the performance of the duties. The House of Lords decision in *Fitzpatrick v IRC 66 TC 407* explained that doing something in preparation for the work is not enough; it has to be ”in the performance of the duties”.

The taxpayer was a journalist who worked for a newspaper. He purchased and studied other newspapers as an essential part of his job. Lord Templeman explained the test:

> “The question … is whether when a journalist reads newspapers he is performing his duties of his employment”.

His Lordship said that he was not, because the journalist did not read the newspapers in the performance of his duties, but to enable his duties to be performed.

Lord Browne-Wilkinson expressed the test similarly;

he said that it was necessary to consider:

> "whether such reading was done in the actual performance of the duties or was merely preparatory and done in order to qualify him, by obtaining background information, to do his job more effectively".

The point is clear and there are many other authorities supporting this interpretation – not that a decision of the House of Lords needs any support.

However, I would respectfully suggest that the wrong target is in the judicial sights here. Whether or not the reading of the newspapers was done in preparation for, or in the performance of, the duties has nothing to do with the entitlement to the deduction. It is the act of incurring the expense (and paying the money) which must be done in the performance of the duties of the employment. Mr Fitzpatrick did not expend money by reading the newspapers; he spent the money when he bought the newspapers. If he called into the newsagents on his way to work and bought a newspaper, the expenditure was incurred at or around the time he picked up the newspaper and paid the money to the shopkeeper. When he spent the money, was he performing the duties of his employment?

Clearly not – unless his job was perhaps to observe the behaviour of shopkeepers at the point of sale of their product.

There are loads of cases on this point – and travelling is another favourite. Although it may seem obvious that the cost of travelling to work is necessary to be able to do the work, not only is the travelling merely preparatory, the authorities explain that expense is actually incurred to enable the employee to live elsewhere.

This is all very unhelpful and just goes to demonstrate what a strict test is imposed by the legislation. The fact that the test is virtually impossible to satisfy has not (unfortunately) caused any judicial flexibility in its interpretation. There are almost endless cases on this subject – and in virtually every one, the taxpayer has failed to satisfy the tests for a deduction.

It is with this background that the recent case of *Kunjur v HMRC TC 8296* comes to be considered. This case concerned a claim for the cost of accommodation incurred by a dental surgeon.

Mr Kunjur was a dental surgeon who practised in Southampton where his family lived. He wished to become a maxillofacial surgeon and accepted a position at St George's Hospital in London. He found the commuting unacceptable and he also had on-call responsibilities where he was required to have accommodation within 30 minutes from the hospital to discharge his on-call duties. Accordingly, he rented modest accommodation in London where he stayed during the week to discharge his on-call duties.

HMRC refused a deduction for this expenditure. Given the terms of the legislation, and the wealth of authorities, that is hardly surprising.

However, the Tribunal found that Mr Kunjur was entitled to a deduction for some of the accommodation costs. The reasoning deserves some examination.

The Tribunal said that Mr Kunjur's duties required him to be able to treat patients within 30 minutes. He could not perform his duties from Southampton and it was unreasonable to expect him to use undergraduate accommodation or to uproot his family. It was therefore necessary for him to rent accommodation in London.

There is so much authority against this proposition it is difficult to know where to start. The first point is perhaps that Mr Kunjur was not obliged to incur this expenditure because of his employment but because he wished to live an inconvenient distance away from his place of work. Whether it was reasonable or not to expect him to use undergraduate accommodation is not a relevant test – reasonableness has never been a criterion. Mr Kunjur may have thought it necessary for his own personal purposes to rent accommodation in London, but that is not a test either. Mr Kunjur had an obligation to be within 30 minutes when he was on call, as required by his employer, but that is no different from his employer requiring him to wear particular clothing to perform his duties or to have a home telephone or to undertake professional reading and study to keep himself up to date with his subject – or masses of other things – none of which represent an allowable deduction.

Accordingly, there is considerable reason to doubt the Tribunal's conclusion that "Mr Kunjur was obliged to incur the expenditure on accommodation in Colliers Wood as the holder of an employment". However, even if he was so obliged, that does not of itself meet the tests required by section 336.

The Tribunal went on to consider the wholly and exclusively test and whether he obtained any personal benefit from the accommodation at times when he was not on call. They concluded that he did not. But this surely cannot be right. Mr Kunjur was not on call 24 hours a day so at the times when he was not on call, he was benefitting from the use of the accommodation.

The Tribunal recognised that there was no requirement for Mr Kunjur to be so close to the hospital on nights when he was not on call, saying that "therefore it was impossible to say that he did not obtain a private benefit" during those times. Bang goes the wholly and exclusively test.

The conclusion of the Tribunal that the accommodation was only partly used in the performance of the duties must have disqualified the expenditure, even if the *necessary* condition was satisfied. But they decided to allow a proportion of the expenditure by reference to the amount of time Mr Kunjur spent giving advice while on-call. The reasoning was as follows:

> "We note that the expression wholly and exclusively is used in the computation of business profits in which context relief is allowed for a proportionate amount of expenditure that is, in fact, used for business purposes. We see no reason to

> adopt a different approach in the context of section 336”.

It is respectfully suggested that there is every reason to consider a different approach in connection with section 336. The statutory test for business profits is different – very different. It is also in a different (and later) statute. It provides the famously different rules which apply to the self-employed. Section 334 ITTOIA 2005 does allow a proportion of an expense in certain circumstances – but that statutory apportionment is conspicuously absent in section 336 ITEPA 2003 in connection with employments – which reflects the much stricter test which specifically applies to employees.

Whilst one can have every sympathy with Mr Kunjur and his situation, he is no different position from countless other taxpayers whose expenditure has not been allowed and even more taxpayers who, knowing the terms of section 336, have been advised not to claim such expenses.

If this decision were to represent the modern interpretation of section 336 I would be the first to rejoice – but I fear this is not the case. My hope (for Mr Kunjur) is that HMRC will not seek to appeal so that

Mr Kunjur will not be exposed to the risk of costs of the Upper Tribunal.

DAMNED IF YOU DO AND DAMNED IF YOU DON'T: FICS, LOANS AND GIFTS WITH RESERVATION

Katherine Bullock

It is generally recognised that in the case of a family investment company (FIC), the danger of engaging the gift with reservation of benefit rules comes from the effective restrictions placed on the shares given away, whether those restrictions are legal or practical. However, in this article, I wish to consider another potential concern that I have seen raised recently in connection with loans made to FICs, gifts of shares and the gift with reservation of benefit code.

The Issue

Imagine a scenario where an elderly couple wish to mitigate IHT. They are advised to establish an FIC to achieve that purpose. They would like to remove future growth from their estate whilst retaining the ability to withdraw the majority of the funds introduced into the FIC tax efficiently should they need them. They therefore establish their company with £100 of share capital and a loan for £1million.

Around the time that they make the loan, they gift 90% of the shares to their children and retain 5% of the shares each. Perhaps the retained shares carry the power to appoint directors or entitle the holders to the majority of votes. The couple become directors of the company and responsible for its day to day operation. If the company pays interest on the loan, have the couple reserved a benefit in the shares gifted?

An interest free loan cannot give rise to a reservation of benefit. The benefit here is clearly a benefit to the donee and not a benefit reserved to the donor. Similarly if the interest is excessive, it seems clear that the donor has reserved a benefit. But what is the position for interest charged at a normal commercial rate? Risk of engaging the settlements legislation code, the transfer pricing rules and the transactions in securities code may lead to a conclusion that interest should be charged at a commercial rate on loans used to fund a FIC. Are there other considerations that suggest, where inheritance tax (IHT) mitigation is the primary objective for establishing a FIC, such loans should be made interest free?

Why it matters

If the gifted shares are subject to a reservation, the consequences may be catastrophic. The gift with reservation rules are penal anti-avoidance provisions and as result their impact can leave the donor's estate worse off than if the gift had never been made. Property subject to a reservation at the donor's death is deemed for IHT purposes to remain comprised in the donor's estate. Further the charge to tax that may arise on death or on release of the reservation within seven years of death is based upon the value of the property at that time and not when the gift was originally made. A gift with reservation is not, therefore, a means of freezing the value of the property at the date of gift. On top of which, as this deeming provision does not apply for capital gains tax (CGT) purposes, there is no increase in the value of the shares to market value on the donor's death. In addition for all other IHT purposes, the shares are the property of the donee and therefore the donee will still be subject to IHT on their death.

The legislation

Finance Act 1986 s.102 provides that there will be a gift with reservation as follows:

> (1) *Subject to subsection (5) and (6) below, this section applies where, on or after 18th March 1986, an individual disposes of any property by way of gift and either –*
>
> *(a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period; or*
>
> *(b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise;*
> *and in this section "the relevant period" means a period ending on the date of the donor's death and beginning seven years before that*

date, or if it is later, on the date of the gift.

The first head (Head A) contained in FA 1986 s.102(1)(a) deals with possession and enjoyment of the property by the donee. The second head (Head B) contained in FA 1986 s.102(1)(b) has two limbs, both of which must be satisfied to avoid a reservation of benefit (Buzzoni v HMRC [2013]EWCA 1684). The first limb is that the gifted property is, as a matter of fact, enjoyed to the exclusion or virtual exclusion of the donor. The second limb deals with collateral benefit to the donor and is that the gifted property is enjoyed to the exclusion or virtual exclusion of any benefit to the donor whether by contract or otherwise. A gift with reservation will therefore arise if any one of these three conditions are met.

Possession and enjoyment are assumed by the donee

To avoid falling within Head A the beneficial interest in the gifted property (here the shares) must effectively vest in the donee (the children). In addition the donee must as a matter of fact enjoy the gifted property. Provided that the gift of shares is effective and the children have assumed possession of them and have the right to enjoy, and do in reality enjoy, any dividends, benefit from any capital appreciation and from any sale proceeds on their disposal, Head A will not be engaged.

The fact that the shares may be subject to general restrictions as to their disposal under the articles of association does not limit the donee's enjoyment of the property gifted. This is the case even if the persons that may acquire the shares include the donor and even if the price at which the shares must be sold is less than market value (see IHTM 14314). The restricted rights must apply to all shares within that class. The position might be different if the shares gifted were subject to specific restrictions such as an option for the donor to buy back the shares on certain events. In this case, the donor may not have been entirely excluded from benefit (see Example 6 at IHTM 14333).

Where the donor of the shares receives a payment of interest from the company, unreasonable interest might encroach on the donee' s enjoyment of the shares by decreasing their value or the ability of the company to pay dividends. However, it is difficult to see how the payment of a commercial rate of interest on borrowings for which the company has a legitimate business need prevents the bona fide assumption of possession and enjoyment of the shares by the donee. We need to move on to Head B.

Property is not enjoyed to the exclusion of the donor

To fall within either of the limbs of Head B, any benefit to the donor must be referable to the gift of shares. Share rights are particularly flexible and their rights to vote, to capital and to income can be carved in many ways. As a person cannot reserve a benefit in an asset that they have never given away, it is particularly important to understand exactly what share rights the couple have gifted to their children. There is a difference between a gift of property with a charge over the property in favour of the donor and a gift of part only of the property with the remainder retained (*Commissioners of Stamp Duties of New South Wales v Perpetual Trustee Co Ltd [1943] AC 425)*.

For the first limb of Head B to be met the gifted property must, again as a matter of fact, be enjoyed to the entire or to virtually the entire exclusion of the donor. Where the property is not land or chattels, it is irrelevant that the donor does not actually derive a benefit because their enjoyment of the property is on arm's length terms. This means that it is irrelevant that the loan bears a commercial rate of interest, if it can constitute a benefit in the shares gifted. The donor gave away the right to enjoy the profits of the company. By taking interest payments from the company, is the donor continuing to enjoy those profits? A useful analogy can be drawn with subsequent remuneration paid to the donor. HMRC gives the following example at IHTM 14334:

> *"Jenny conveys land into the joint names of herself and her daughter, Tilly. From then until her death 10 years later Jenny receives not only her share of the rents and profits but also a fee for managing the land.*
>
> *Notwithstanding the decision in Oakes v Commissioner of Stamp Duties of NS Wales [1954] AC 57, no GWR claim should be raised in these circumstances alone provided the fee paid was entirely reasonable in the light of the actual services rendered. "*

A benefit by contract or otherwise

We therefore need to consider the second limb of Head B. The second limb is satisfied if three conditions are met. Firstly, the donor's benefit must be by virtue of and referable to the property gifted (see *Ingram)*. Secondly, the benefit to the donor must consist of an advantage which the donor did not enjoy before he or she made the gift (see both *Buzzoni* and *Lady Hood)*. Thirdly, there must be detriment to the donee (see *Buzzoni*).

Where the loan is made before the gift of the shares and the gift is in no way subject to or dependant on the gift such that it can be successfully argued to be an associated operation, the second condition cannot be met. The donor clearly enjoyed the advantage of the contractual right to interest before the gift was made and there is no benefit by contract or otherwise referable to the gift. HMRC appear to accept that this is the case for reasonable remuneration agreed before the gift. In their manuals at IHTM14337, HMRC provide:

> *The continuation of existing reasonable commercial arrangements in the form of remuneration and other*

benefits for the donor's services in a business entered into before the gift does not amount to a reservation provided the benefits are in no way linked to, or affected by, the gift.

What is 'reasonable' will depend on all the facts but, broadly, you should test this by reference to what might reasonably be expected under arm's length arrangements between unconnected parties.

However they leave open the position where new arrangements are made as part of the overall transaction.

If, however, as part of the overall transaction, including the gift, new remunerative arrangements are made you will need to examine all the facts to determine whether the new package amounts to a reservation 'by contract or otherwise.

Is the position different where the loan is made after the gift? Here it is possible to fall back on the third condition. If the loan is made at an arm's length and carries a commercial rate of interest, the donee will not have suffered any detriment and again the conditions of the second limb will not be met.

Conclusion

In conclusion, regardless of when the loan is made and whether it is interest free or carries a commercial rate of interest, there should be no cause for concern under the gift with reservation rules. It is possible that the associated operation provisions might apply, but it is difficult to see how. The loan has to be repaid; interest has to be paid whether or not the company is in profit. This does assume that the gift of shares is outright and absolute and with no continuing advantage and that the loan interest is not excessive. However there are and remain many reasons why practitioners should consider carefully both the structure and balance of equity and debt on the formation of a FIC. In some instances, practitioners may prefer to avoid the issue altogether and instead deploy redeemable zero coupon preference shares. Perhaps a story for another day.

BREXIT: THE BIG INDIRECT BREAK?

Following Brexit, should the UK Government lower VAT rates?

Dilpreet K. Dhanoa

"When a new source of taxation is found it never means, in practice, that the old source is abandoned. It merely means that the politicians have two ways of milking the taxpayer where they had one before."[1]

Whilst economists argue that leaving the EU has had negative consequences for the UK, the fact is that the precise costs are unknown.[2] Brexit was not the only major event to have significantly impacted the UK in 2020-2021 either. Globally, no country was left untouched in the wake of the COVID-19 pandemic. Although much has been discussed with respect to the impact of Brexit, the reality is that its impact in the arena of taxation is not as significant as may have been anticipated by some.

1 H . L. Mencken (early 20th century).
2 C. Giles, Financial Times, 'Brexit one year on: the impact on the UK economy' (23 December 2021).

One arena in which there has been a noticeable impact, and will be in the years to come is that of indirect taxation – in particular, VAT. There has been some argument that since departing the EU, the UK should consider amending its VAT regime. In particular, following the government's consultation[3] on the subject, there was some debate around whether the compulsory VAT registration threshold would be lowered.[4] There is some argument that indirect taxation could provide an attractive route to 'stealth' collection of taxes, as the government looks to replenish funds made available to individuals and businesses during the pandemic.

Altering the VAT regime must begin by understanding what are the motivations for having a VAT in the first instance. The UK adopted the EU model of VAT when it originally joined as a Member

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3 UK Government: Consultation Outcome: VAT registration threshold: call for evidence, 29 October 2018 (https://www.gov.uk/government/consultations/vat-registration-threshold-call-for-evidence) (Accessed: 23 May 2022).

4 See: 'What will it mean if Philip Hammond lowers the VAT threshold to 45k?' (https://www.companydebt.com/articles/what-will-it-mean-if-philip-hammond-lowers-the-vat-threshold-to-45k/) (Accessed: 7 June 2022).

State in 1972, and has chosen to maintain that model despite the formal departure from Europe (in the wake of Brexit). The EU VAT model was founded on two key principles:

1) VAT as a general consumption tax (for raising revenue purposes); and,
2) the principle of fiscal neutrality.[5]

The impact to both of these pillars that form the foundation of VAT need to be assessed when considering the lowering of the VAT threshold. In addition, secondary effects, such as socio-political impacts, will also need to be considered.

Motivations for a Lower Threshold

Lowering the VAT threshold may seem an attractive method of raising tax revenues for the government; after all, it increases the potential tax base as more businesses fall within the obliged scope and requirements of paying VAT. It perhaps makes even more sense given that the UK lies at one extreme of the VAT registration thresholds in a European

5 de la Feria, R., 'EU VAT Principles as Interpretative Aids to EU VAT Rules: The Inherent Paradox', in Lang, M., *Recent VAT Case Law of the CJEU* (Vienna: Linde, 2016), p. 1.

context: the UK's current registration threshold of £85,000 per year is so high that most small businesses (sole proprietors and small ventures) are generally outside the VAT net. At the point of the UK's formal departure from the EU (1 January 2021), there were a total of 5.6 million private sector businesses.[6] Of those, less than half were registered for VAT (as at March 2021): meaning, approximately 2.77 million were registered,[7] resulting in 2.83 million unregistered businesses. Also as a revenue generating mechanism, it is considered as very effective (in fact, some arguments against VAT are that VAT does *"too good a job of raising revenue"*[8]).

To assess the potential increase in government revenue, the first step should be assessing the taxable revenue elasticity, akin to the Laffer curve except that we substitute the VAT threshold as the independent variable rather than the VAT rate and applied to the taxable revenue rather than taxable income. Whilst this detailed analysis requires further probative

6 House of Commons Library, Research Briefing: Business Statistics (21 December 2021), p. 4.

7 Office for National Statistics: Census 2021 – UK business; activity, size and location: 2021 (4 October 2021).

8 M. Keen, Int Tax Public Finance (2007) 14: 365-381, Presidential Address, 2006, *VAT Attacks!*, p.365.

analysis, it highlights the two conflicting forces in play when lower the VAT threshold, namely, the ‘arithmetic effect’ (an increase in taxable base will increase revenue, R, since

$$R = t \times B \tag{1}$$

where t is the VAT rate at the threshold and B is the taxable base) and the unfavourable ‘economic effect’ (an increase in taxation will change the behaviour for those who are now above the threshold).

Regressivity & Distortions

Firstly, lowering the VAT threshold will increase the regressivity of the tax since only those businesses earning lower revenues will be adversely impacted. Secondly, a higher tax rate for those business that now move from below, to above the VAT threshold, could negatively impact their business through three mechanisms:

1) higher tax rate increases their costs of doing business (as tax administration and compliance costs will need to be factored in);

2) increase in prices for the end customer which will reduce their total output

depending on the elasticity of demand for their products; and,

3) a combination of the first two points will make those businesses now impacted less competitive and confer a competitive edge to enterprises exempted in this way from the VAT[9].

This affects both pillars that form the foundation of having VAT in the first place. The points highlighted will not only lead to a decrease in potential revenue, but since VAT is a transactional tax, a reduction of the threshold has the capability of distorting economic behaviour[10], directly conflicting the second pillar of fiscal neutrality of VAT. It is noted, however, that *"the incidence of this regressivity is very country specific and generalisations can be misleading and VAT can be more progressive than that of trade taxes "*[11]. The UK would therefore need

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9 ITD Publication Decade Sharing Experiences: https://www.oecd.org/tax/tax-global/ITD-publication-decade-sharing-experiences.pdf (2013) ('ITD Report') (Accessed: 23 January 2018), p. 67

10 *Ibid.*, p. 21

11 *Ibid.*

to undertake modelling to understand any regressivity impact in a post-Brexit world.

The moment a business starts trading, unless there is compulsory registration,[12] any threshold will create an incentive for some businesses to try and operate below it.[13] In the current context, this leads to bunching (large number of businesses operating just below the threshold) and the Office of Tax Simplification ('OTS') Report notes that the fall-off in business numbers immediately after is a reflection of the significance to a business of crossing the mandatory VAT threshold.[14] It becomes an *"undesirable complexity"*[15] when the administrative and economic effects play such a significant part in the design of such a tax and in particular in whether

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[12] E.g. Greece, Hungary, Spain and Sweden (all have a nil threshold requiring traders to register the moment they start making a profit).

[13] Value Added Tax: Routes to Simplification (OTS, 2017) ('OTS Report'): https://www.gov.uk/government/publications/ots-report-on-routes-to-simplification-for-vat-is-published (Accessed 25 January 2018), p. 9

[14] *Ibid*, p. 6

[15] *Ibid*, p. 7

or not a threshold should be raised or lowered. It can be *"potentially economically distortive"*.[16]

The UK government should analyse the degree of bunching to assess significance of the threshold. If the level of bunching is considered high, it impacts the governments in two ways; first, it highlights that the threshold is significant so if the threshold was to be lowered, the incentive is for businesses would be to adjust accordingly and to simply lower the level at which bunching occurs. This gets incrementally more difficult the larger the change in threshold, so any move lower in threshold should be substantial if bunching is high. Secondly, it highlights that the level of competitive distortion could be high as businesses find it significantly more profitable to operate below the threshold. A large drop in the threshold would therefore reduce this competitive distortion significantly. Analysis has been done considering the impact of lowering the threshold significantly to £43,000; this would be almost cutting the current threshold by half making it much harder for businesses trying to evade VAT to remain undiscovered.[17] A significant reduction (say from

[16] *Ibid*, p. 7
[17] *Ibid*, p. 9.

current levels to £43,000[18]), would impact around half a million small businesses.[19] This would have the benefit of reducing the unregistered business population, and thus reducing competitive distortions.[20]

Impact of Costs

A further problem with VAT is that whilst it is one of the greatest and quickest revenue raisers in theory, there is an issue from a practical perspective: consideration must be given to the costs of lowering the VAT threshold. Using an analogy from Physics, a parallel can be drawn to the 'Observer Effect', whereby simply observing a situation or phenomenon necessarily changes that phenomenon[21]. For the government to monitor and

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18 This is the figure used by the OTS in its studies and is used here due to the fact that the data has been tested rigorously and has rendered specific results which can be considered relatively reliable for the purposes of this paper (OTS Report, *ibid.*, p. 9).

19 The OTS considers this to be in the region of 400,000-600,000 (Value Added Tax: Routes to Simplification (OTS, 2017): https://www.gov.uk/government/publications/ots-report-on-routes-to-simplification-for-vat-is-published (Accessed 25 May 2022), p.9).

20 *OTS Report*, p. 9.

21 M. S. de Bianchi, 'The Observer Effect', Foundations of Science (September 2011).

collect the additional VAT will distort the theoretical amount it is in actual fact able to collect, since there will be (potentially significant) costs involved in actually collecting the tax.

Certainly, it is true that the UK is a more complex economy and more advanced in VAT terms so the burden of collecting the taxes is not as high as it would be in less developed countries. However, with considerations like the Flat-Rate Scheme (which can be complex for the government to administer) and trying to encourage small businesses (that may not all have the right infrastructure) to engage with the 'Make Tax Digital' (MTD) movement may prove to be more costly, and potentially outweigh any fiscal benefits to be obtained. Moreover, the UK already has a system to collect VAT in place so any revenue raised would be to assist directly with the purpose of satisfying the revenue raising aspect of VAT.

Nevertheless, the costs of lowering the VAT threshold could still be significant. Indeed, *"exempting small firms from the VAT system reduces the number of firms that have to be taxed very sharply – and hence makes a significant saving in the costs of tax administration and compliance –*

while forgoing little in terms of tax revenue"[22]. An important consideration is the fact that the costs of collecting taxes are very unlikely to be linear to the reduction in threshold – decreasing the threshold increases the probability of sophisticated VAT fraud[23] as more business are incentivised to remain below the new threshold (especially if large bunching effect), increasing the difficulty of the task and costs faced by the regulator arguing *"towards restricting the set of VAT payers by leading to a relatively high threshold"*[24].

The UK Government need to consider the 'compliance burden' on businesses with respect to VAT regulation.[25] The UK currently has one of the highest VAT thresholds in the world, but this allows many small businesses to avoid having to deal with complex VAT compliance.[26] The costs will also be borne by the private sector and it is here that regressitivity increases further: the overall cost of compliance is likely to include a significant fixed

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22 VAT Report Evaluation, *op. cit.*.
23 M. Keen, op. cit., p.365.
24 ITD Report, *op. cit.*, p.67
25 De Voil Indirect Tax Intelligence, Streamlined Efficiency or the Burden of Compliance, Simon Newark
26 OTS Report, *op. cit.*, p.2

element for each firm taxed, and for the smallest firms this fixed cost is likely to be large relative to the tax that would be collected from the firm[27].

From an economics perspective, the optimal level of threshold is the level at which the marginal revenues at the threshold is equal to the marginal costs. Any deviance from this equilibrium level incentivises the government to have a different threshold. This can be expressed as:[28]

$$(D-1)tVZ = DA + C \qquad (2)$$

where D is the marginal cost of public funds, A and C are administrative costs borne by the revenue authorities and compliance costs borne by firms respectively, t is the VAT rate, Z the turnover threshold, and V the share of value-added in turnover. Rearranging this equation for the optimal threshold Z^*

$$Z^* = \frac{DA + C}{(D-1)tV} \qquad (3)$$

Even if lowering the VAT makes economic and fiscal sense, politically and as a policy it may cause more

27 VAT Report Evaluation, *op. cit.*
28 *Ibid.*

problems as traditionally the threshold has only ever been increased. The effect of this may be amplified more than the government could anticipate, as it affects future expectations. The concept of signalling used in economics is important here to manage expectations of further VAT decreases; so an approach of one large decrease in the VAT threshold, rather than a smaller incremental one, will help anchor business expectations and prevent any adverse secondary effects on investments.

The government also needs to consider the impact the reduction in the VAT threshold has on social equality. Those that register are entitled to recover input costs (where applicable), and in any event will pass on most of the cost. That is how the mechanics of VAT works. As noted by various academics and practitioners,[29] it is the poorest members of society who spend a higher proportion of their disposable income on VAT, and thus will end up bearing more of it (as end consumers).

Artificially Lowering the VAT Threshold

[29] Polomarkakis, K. A. (2016), 'The European VAT Oxymoron: A pragmatic solution for welfare, especially in times of crisis?', Journal of International and Comparative Social Policy, 32(3) (Cambridge University Press, 9 March 2020).

There may be alternative methods to directly reducing the VAT threshold that achieve the objective of raising revenues for the government.

Freezing the VAT threshold could increase revenues through two mechanisms. Firstly, as equation (3) above highlights, the optimal level of VAT threshold is linear to costs, both administrative and compliance to the government and businesses respectively. It follows that by lowering the costs for both government and businesses lowers the equilibrium threshold, ceteris paribus. Should the government reduce the costs, by freezing the threshold it will now be operating at a level above the equilibrium threshold where the marginal revenue is above the marginal cost leading to greater "profits" for the government and increasing its 'yield' on the current tax base.

Another method in which costs may be reduced could be to make the VAT simpler: the simpler the VAT, in terms of the extent of rate differentiation and product-based exemption, the lower are implementation costs likely to be and hence the lower the optimal VAT threshold.[30] Whilst this may

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[30] ITD Report, *op. cit.*, p.67

be difficult in the current context in the confines of the EU, the UK could use the opportunity that Brexit presents to reform its VAT laws to smooth the administrative impact of collecting tax revenues. VAT as an EU-driven tax currently has a number of restrictions on it given the centralised nature of the main body of rules and regulations. Accordingly, a number of the smoothing mechanisms are unlikely to be possible under retained EU law.[31] It should be noted however that moving away from the current EU system will cause further problems. If the UK takes a different route to that being proposed by the EU in the aftermath of Brexit, then trading with the EU could become even more complex – at least administratively (than it has been since Brexit) and the UK will not reap the benefits of any simplifications being proposed in the Commission's announcement.[32] Smoothing mechanisms which could be considered are:[33] smoothing the cash impact of becoming registered, smoothing the administrative impact, smoothing both cash and administration and time-limited reduction in the

31 OTS Report, *op. cit.*, p.9
32 *Ibid.*, p.9
33 *Ibid.*

VAT Flat Rate Scheme for newly-registered businesses and a financial taper.

The second mechanism by which freezing could increase revenues is through inflation. VAT, like all form of taxes, is a tax on nominal values rather than real values. Through inflation, more businesses will be above the threshold as prices increase and they generate more revenue. By freezing the threshold in nominal terms, an increase inflation decreases the threshold in real terms. One point to note however that the impact of this is balanced by a reduction in the revenues for the government in real terms. Given the current low levels of inflation, the impact through this mechanism will be longer term through the compounding effect of inflation through time.

Conclusion

The final decision ultimately depends on the government's urgency for revenue needs[34] and how important it deems the social impact of lowering the threshold to be. The additional administrative costs, potential increase of tax fraud and increasing regressivity mean that a reduction in the threshold should be avoided if possible. The methods of

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34 ITD Report, *op. cit.*, p.67

artificially reducing the VAT threshold described above should first be pursued before a reduction. If a reduction is deemed necessary, then it is argued that it should be large enough to reduce distortions and prevent adverse effect on business investments through the signalling mechanism.