





Tax Bulletin

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PENALTIES AND THE NEW TRANSFER PRICING LEGISLATION

The 1998 Finance Act ('FA 98') introduced new transfer pricing legislation, affecting all accounting periods ending on or after 1 July 1999 and years of assessment 1999/2000 *et seq.* At the time of the Budget the Revenue undertook to provide guidance on a number of issues raised by these changes. Notes on record keeping and funding were published in October's *Tax Bulletin*; this third guidance note concerns penalties.

Among the changes made by FA 98 is the abolition of the direction requirement at Section 770 (2)(d) Income and Corporation Taxes Act 1988 ('ICTA 1988'). The removal of this requirement means that, for the first time, taxpayers entering into transactions and arrangements covered by the new legislation will be obliged to make tax returns in accordance with the arm's length principle. This in turn raises the possibility, again for the first time, of penalties under Section 95 or 95A Taxes Management Act 1970 ('TMA 1970') or Paragraph 20, Schedule 18 FA 98 where:

- a return is made which is not in accordance with the arm's length principle;
- it can be shown that the return was submitted fraudulently or negligently by the taxpayer; and
- UK tax is lost as a result.

This is consistent with the Government's desire to create a fairer transfer pricing regime, one which

encourages voluntary compliance and deters, and if appropriate penalises, non-compliance.

It is worth saying first of all that although penalties arising from fraudulent or negligent conduct have not previously been imposed in a transfer pricing context, they are not in themselves new. The Revenue has already published guidance on them in the Investigation Handbook at paragraphs 4720 ff. That general guidance holds good for transfer pricing purposes; there are, however, one or two extra points to be made which are specific to transfer pricing. This note deals first with the main general issues, then turns to those particular to transfer pricing.

General

A penalty can only be charged under Section 95 or 95A TMA 1970 or Paragraph 20, Schedule 18 FA 98 where UK tax has been lost through fraudulent or negligent conduct by the taxpayer.

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The maximum penalty which may be charged is an amount equal to the tax lost by reason of the offence. However, an officer authorised by the Board can, under Section 100(1) TMA 1970, determine the penalty at such amount as is, in his opinion, appropriate. The Board's policy in negotiated settlements is to abate any penalty to an appropriate percentage of the culpable tax recoverable by assessment for all years which are not time-barred for penalty action. A penalty measured by reference to tax lost is called a 'tax-gear'd' or 'tax-related' penalty. This guidance deals with tax-gear'd penalties only (as opposed to flat rate penalties, such as those chargeable under Paragraph 23, Schedule 18 FA 98 for a failure to keep proper records).

The factors which the Board takes into account when considering abatement are described in leaflet IR 160 and at Investigation Handbook paragraphs 5525 ff. These will apply to penalties arising from transfer pricing adjustments. See also the further comments under 'Size and gravity' below.

Transfer Pricing

Importance of OECD Guidelines

The Revenue's approach to the matter of penalties will be consistent with that set out in Chapter IV of the 1995 *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, published by the Organisation for Economic Co-operation and Development ('OECD') and available from HMSO in the UK or the OECD at 2 rue André-Pascal, 75775 Cedex, France.

Negligence

One of the main concerns of business in relation to transfer pricing and penalties is what is meant by 'negligence', given that to some extent what is an arm's length price is a matter of judgement and there is not always one 'right' answer. Where taxpayers can show that they have made an honest and reasonable attempt

to comply with the legislation, there will be no penalty even if there is an adjustment. Indeed, the onus will be on the Revenue in this area, as it is more generally, to show that there has been fraudulent or negligent conduct by the taxpayer before any penalty can be charged. Examples 3 and 4 below illustrate adjustments which will not give rise to a penalty.

Neither the Courts nor the Revenue have ever attempted a detailed definition of 'negligence'. Each case is to be judged on its own facts and merits, with the guiding principle being that a person is not negligent if he or she has done what 'a reasonable person would do'. There is therefore an obligation on taxpayers to do what a reasonable person would to ensure that their returns are made in accordance with the arm's length principle. This would involve, but not be limited to:

- using their commercial knowledge and judgement to make arrangements and set prices which conform to the arm's length standard (or to make computational adjustments in their returns where they do not);
- being able to show (for example, by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm's length standard and with the legislation;
- seeking professional help where they know they need it.

Taxpayers will want to document what they do to the extent necessary to enable them to sustain the arm's length nature of their arrangements and prices in any discussions with the Revenue. Guidelines on what records should be kept were published in October's *Tax Bulletin*; taxpayers who act in accordance with that guidance should not find themselves facing penalties on account of fraudulent or negligent conduct. Taxpayers should bear in mind, though, that detailed

documentation will not *in itself* free them from the possibility of a penalty, if that documentation does not show that they had good grounds for believing their arrangements and prices to be in accordance with the arm's length principle.

Negligence: examples

The following examples are designed to give a broad understanding of how the Revenue will interpret 'negligence' in transfer pricing cases. They are not exhaustive, and it cannot be stressed too strongly that each case can only be properly judged on its own facts and merits. The examples address only the issue of what constitutes negligence in transfer pricing cases, and do not duplicate or replace the general guidance on penalties found in the Investigation Handbook and IR 160.

It should also be made clear that the percentage mark-ups mentioned in the examples are not to be taken as indicative of the Revenue's view of the 'right' or 'wrong' mark-up in particular real life cases. All figures used are illustrative only.

Example 1

A company whose business is to provide services to other group members charges out its services at cost plus 5%. 5% accords with a policy in place throughout the group, and is documented in correspondence involving members of the main Board, the Finance Directorate, and the Tax Department; and in a group agreement. It is established in discussion with the Revenue that the arm's length range for the services in question is 10% - 15%. The company cannot show from its records that it even considered whether its own 5% rate complied with the arm's length principle. The Revenue would view any tax lost as a result of the undercharge as having been lost through

negligence, and would wish to consider a penalty.

Example 2

As example 1, except that in the correspondence it is asserted several times that the group's policy is to comply with the arm's length standard, and that 5% is an arm's length price. However, the company is unable to bring forward any convincing evidence in support of its assertions, while the Revenue is able to show that an arm's length price would be in the 10% - 15% range. The Revenue would wish to consider a penalty.

Example 3

As example 1, except that the company charges out at cost plus 8%, and can show that at the time the rate was set it had run a check of available industry data, and had found what it considered to be a comparable uncontrolled price supporting the 8% rate. In discussion with the Revenue, the company agrees that the comparable it used was flawed, and that the weight of evidence points towards a price in the 10% - 15% range. The Revenue accepts that the company had made an honest and reasonable attempt to comply with the arm's length principle. There is an adjustment but no penalty.

Example 4

A company whose business is to provide services to other group members charges at cost plus 5%. As in example 1, 5% accords with a policy in place throughout the group, and is documented in correspondence and a group agreement. The company includes an adjustment in its

computation, bringing the effective rate of charge-out up to 8%. It did so after searching available industry data for possible comparable uncontrolled prices, this search being made at the time the tax computation was being prepared. As with example 3, the company sees this information as supporting its opinion that 8% accorded with the arm's length principle, but it later agrees that the price should have fallen in the 10% - 15% range. Once again, the Revenue accepts that the company had made an honest and reasonable attempt to comply with the arm's length principle, and there is an adjustment but no penalty.

'Size and gravity'

In considering what abatement should be available in respect of 'size and gravity', the Revenue will take into account all of the following:

- the absolute size of the adjustment;
- the size of the adjustment relative to the turnover and profitability of the business against which the adjustment is being made; and,
- where this is possible, the size of the adjustment in relation to the volume and value of the related party transactions giving rise to the adjustment.

Head Office monitoring

The Revenue recognises that the issue of penalties on transfer pricing adjustments will be a sensitive one, especially in the early years of the new regime. As a result, and to ensure that a consistent approach is taken across the department, all potential penalty cases will be monitored by International Division, working in conjunction with Compliance Division.

Any questions on this guidance should be directed to:

Richard Coombes
International Division
Room 409, Melbourne House
Aldwych
London
WC2B 4LL

Tel: 0171-438 6842
Fax: 0171-438 7518

TAX LAW REWRITE PROJECT

The Tax Law Rewrite project published its third Exposure Draft - "Capital Allowances: Part 1" on 29 October 1998. The Exposure Draft invites comments on a rewrite of the capital allowance provisions relating to industrial buildings. Publication of the draft clauses at an early stage ensures that the views of users can be taken into consideration. The project team fully expect to make changes to the clauses in the light of this consultation. Comments are asked for by 15 January 1999.


Copies of the Exposure Draft can be obtained free of charge from:

Inland Revenue Information Centre
Bush House, South West Wing
Strand
London
WC2B 4RD

It can also be found at the project's website at:
<http://www.open.gov.uk/inrev/rewrite.htm>

IHT: GUIDANCE ON CHANGES TO THE CONDITIONAL EXEMPTION SCHEME

Finance Act 1998 makes a number of changes to the conditional exemption scheme for heritage assets. We will be issuing general guidance on these changes and their practical application by January 1999.

THE NEW SYSTEM FOR TAXING PROFESSIONAL BUSINESSES: WHAT IS MEANT BY 'TRUE AND FAIR VIEW'? 

The Finance Act 1998 made substantial changes to the way in which the profits of professional businesses are computed for tax purposes. The most important is that professional businesses will no longer be able to compute their profits on a 'cash' or 'conventional' basis. Instead, with effect from the first accounting period beginning after 6 April 1999, they must adopt a basis which gives a 'true and fair view' of profits.

The Inland Revenue and the Tax Faculty of the Institute of Chartered Accountants in England & Wales have been discussing what guidance can be given on the implications of 'true and fair view' and have agreed on the note that follows. We are also grateful to the Institute of Chartered Accountants of Scotland and the Chartered Association of Certified Accountants for their suggestions.

We are discussing with other professional representative bodies what guidance can be given for particular professions. We also intend to publish guidance on the working of the 'catching-up' charge which will arise when professional businesses change to the new basis.

Withdrawal of cash basis: guidance note on a true and fair view

Introduction

1. This note has been prepared by the Tax Faculty of the Institute of Chartered Accountants in England and Wales and agreed by the Inland Revenue who intend to include it in guidance to local tax offices.
2. The object of this note is to provide guidance on computing taxable profits

of professional businesses so as to show a true and fair view of profits for tax purposes. The Inland Revenue has told us that their guidance to inspectors on enquiries into work-in-progress stresses that an element of judgement is involved. We attach as Annex A an extract from the Revenue's forthcoming guidance to Inspectors. The full guidance will be published in the Revenue Manuals in due course when it has been finalised.

3. This note is designed to give practical help based upon Accounting Standards and practices current at November 1998. The Tax Faculty will keep under review the need to update this note as Standards and Practices evolve.

Background

4. The Government announced on 22 December 1997 the withdrawal of cash basis practices for computing taxable profits of professional businesses in favour of a 'true and fair' approach.

5. In summary, the proposals are:

- a) Statements of Practice A3 (cash basis for barristers) and A27 (cash bases for others) will cease to apply after 1999/2000; and
- b) for 2000/2001 onwards profits for tax purposes must be based on accounting standards adjusted as required or permitted by tax law.

6. Head (b) in fact is the corollary of head (a). What is proposed is merely that the approach adopted by the Courts over many years, and re-emphasised recently in such cases as *Gallagher v Jones* (1993, 66 TC 77) and *Johnston v Britannia Airways Ltd* (1994, 67 TC 99), should be codified, making explicit by statute that which is already implicit in judicially developed doctrine.

7. The Revenue view of what this means is set out in paragraphs 24-26 of their March 1998 Budget Day Press

Release IR 29 which is reproduced in Annex B.

8. There have been concerns that true and fair implies an audit and compliance with Companies Acts disclosure requirements. These concerns are misplaced: the legislation specifically confirms that no audit or Companies Acts disclosure requirements are imposed.

Date from which effective

9. Paragraph 3 of the Annex to IR 29 referred to above states that "The first computations on the earnings basis will normally be for the twelve months ending on the accounting date in 2000/01. The debtors, creditors and work-in-progress used to calculate the catching-up charge at the end of the previous period will form the opening earnings basis figure." Special rules apply for periods of account other than one year.

What is a true and fair view?

10. The concept of true and fair view is well known to accountants. It has been the fundamental basis of audited accounts for many years. Accounting Standards have been developed and published since the issue of SSAP 1 (Accounting for associated companies) in January 1971. These are required to be used in preparing accounts intended to give a true and fair view. As such, they are integral to the concept of a true and fair view. This is of course a dynamic concept. As new Standards and ASB pronouncements are published they will need to be taken into account in determining whether accounts give a true and fair view. However, Accounting Standards have been developed largely in the context of accounts prepared by companies which, in addition to giving a true and fair view, have to comply with disclosure requirements under the Companies Acts.

11. As accounts (and the Standardised Accounting Information (SAI) section of the tax return) are needed to

quantify the amount of taxable profits, the tax requirement for such documents to show a true and fair view requires them to comply only with those parts of Accounting Standards that are germane to the calculation of profits. Many Accounting Standards affect the presentation of the profit and loss account and the balance sheet and the disclosures to be made by way of notes. For tax purposes such Standards only need to be applied so far as relevant and material to the computation of profits, ie to determine when profit arises and the amount of profit to be recognised.

12. Two standards which are of great importance to accounting by professional businesses are those parts of SSAP 2 (Disclosure of Accounting Policies) which set out the four fundamental accounting concepts and SSAP 9 which relates to the valuation of stock and long-term contracts. The definition of stock as found in paragraph 16(d) of SSAP 9 states that it includes products and services in intermediate stages of completion. This clearly includes work-in-progress in a professional business.

13. SSAP 2 lists going concern, accruals, consistency and prudence as being four fundamental accounting concepts regarded as having general acceptability. To all intents and purposes, these are the same as the accounting principles codified in paragraphs 10-14, Schedule 4, Companies Act 1985 and reproduced in the Financial Reporting Standard for Smaller Entities (FRSSE). As noted in Annex B, the Revenue additionally accept the concept of materiality in arriving at a true and fair view of work-in-progress.

14. We include in Annex C a list of the other Accounting Standards that may need to be applied in particular circumstances.

15. The FRSSE, issued in November 1997, is relevant to many partnerships. It specifically makes clear that

Accounting Standards are intended to apply to unincorporated entities as well as companies. But the main purpose of the FRSSE is to collect together in one place most of the requirements that small entities must follow.

16. A small entity for the purpose of the FRSSE follows the Companies Act criteria, ie a sole proprietor or partnership will be a small entity for any accounting year in which it does not exceed two or more of the following criteria:

Turnover	£2,800,000
Balance sheet total	£1,400,000
Average number of employees	50

17. Although "balance sheet total" under the Companies Acts is defined by reference to the statutory company accounting formats, it is clear that it means assets, ie neither liabilities can be netted off nor capital account balances can be deducted in arriving at the balance sheet total. An overdrawn capital account balance is not an asset.

18. The Foreword to Accounting Standards makes clear that the CCAB bodies expect their members to observe Accounting Standards and to justify any significant departure from them. It also states that compliance with Accounting Standards (other than in relation to immaterial items) "will normally be necessary for financial statements to give a true and fair view".

Valuation of work-in-progress

Introduction

19. Many people are concerned about how one values professional work-in-progress. The first thing to be said is that work-in-progress, like stock, is an accounting concept. It is not for the Revenue to determine how to value it; it is solely a matter of the appropriate application of accountancy principles.

Valuation

20. The basic principle, which is set out in SSAP 9, is that work-in-progress

should be stated at the lower of cost and net realisable value. In the case of long-term contracts paragraph 28 of SSAP 9 requires each contract to be assessed as contract activity progresses. Paragraphs 28 to 30 give further guidance as to how this should be done. This part of SSAP 9 was an issue in *Symons v Weeks* (56 TC 630). This case emphasises the principle that profits should not be anticipated and that in ascertaining profits actually earned up to the balance sheet day inherent uncertainties as to the outcome of a contract require a cautious estimate of such profit to be made.

21. SSAP 2 is also relevant. The accruals concept requires that revenue and costs are "matched with one another so far as their relationship can be established or justifiably assumed and dealt with in the profit and loss account of the period to which they relate".

22. The purpose of work-in-progress is to relate expenditure on such work to the period in which the income it produces is earned. Accordingly if there is no expenditure there is no work-in-progress to be matched with the income of a later period. There is of course no expenditure included in the profit and loss account in respect of the proprietor's or partners' time because it is an appropriation of profits; accordingly there is nothing to be carried forward in respect of such time.

Chargeable staff

23. A sole trader or partnership with no chargeable staff, ie fee-earning employees, will accordingly have no work-in-progress.

24. If an accountancy practice has chargeable staff, it will have work-in-progress. The starting point for valuing work-in-progress is that salaries and other costs directly attributable to productive staff, such as national insurance and pension contributions, should be matched with the earnings that their work generates. The principle

is to carry forward costs that relate to a later period, not to anticipate profits that will not be earned until a later period.

Overheads

25. The key area of difficulty is what, if any, overheads should be included in the calculation of work-in-progress. The only case which appears to relate directly to the recognition, or otherwise, of overheads for tax purposes, *Duple Motor Bodies v Ostone* (1961, 39 TC 537) was decided before the introduction of SSAP 9. In that case the Commissioners found as a fact that the company's policy of including only direct costs in the valuation of its work in progress accorded with generally accepted accounting practice. It is unlikely that such a policy would now accord with SSAP 9 and so it would no longer accord with generally accepted accounting practice.

26. Paragraph 17 of SSAP 9 defines cost as including such costs of conversion as are appropriate to the stock's condition. Paragraph 19 states that cost of conversion includes production overheads (as defined in paragraph 20) and any other overheads attributable in the particular circumstances of the business to bringing the product or service to its present location and condition. SSAP 9 was issued in 1975, although it was revised in September 1988, mainly to cover long term contracts. At that time few, if any, professional practices were incorporated. Accordingly the Standard does not specifically address the question as to what extent overheads of a professional practice constitute "costs of conversion" in relation to work-in-progress. The SSAP 9 definitions are more appropriate to manufacturing operations.

27. Perhaps because there was no 'true and fair view' requirement, this is an area on which there does not appear to have been a consensus amongst practising accountants. Some firms of accountants that currently prepare

accounts on an earnings basis exclude overheads whereas others include them. There has been no standard method of ascertaining overheads even where these are included.

28. However, the Revenue accept that the concept of materiality applies and believe that this obviates many of the potential problems. They have told the Tax Faculty that they do not wish to put firms, particularly small firms, which may not have the necessary overhead information readily available, to a considerable amount of extra work for little benefit.

29. On this basis the following approach will normally be acceptable, assuming of course that work is normally billed on a regular basis.

- a) The Revenue accept that overheads can be ignored in relation to a sole practitioner or partner's own time - so the value of work-in-progress for their time will be nil as there can be no work-in-progress in relation to a proprietor's labour.
- b) They are prepared to accept that in most cases overheads in relation to staff time of a sole practitioner are likely to be immaterial.
- c) Similarly in a two, three or four partner firm staff overheads can legitimately be regarded as immaterial in most cases. However this may depend to an extent on the ratio of partners to productive staff.
- d) In a large firm, with many fee-earners located in substantial premises, it is right to recognise a fair proportion of overheads in calculating work-in-progress.
- e) In the intermediate range it will normally be appropriate to recognise overheads, although at the smaller end of the range the Revenue would not object to the adoption of a fairly rough and ready approach to arriving at an appropriate figure.

The Tax Faculty believes that this is a reasonable approach to adopt.

Larger firms

30. Applying the above guidance will be straightforward for smaller firms where work-in-progress is not material. In the case of larger firms each case must be considered on its own merits and in accordance with existing guidance on the valuation of work-in-progress contained in SSAP 9 and the concept of materiality whereby immaterial items can be ignored. In addition it is important to recognise the concept of consistency so that work-in-progress is valued on a consistent basis as between one accounting period and the next. It is unlikely that any work-in-progress in an accounting practice would fall to be regarded as a long term contract under the terms of SSAP 9, but it may do so in other professions; for example, architects, solicitors, surveyors and others. Treatment of contingent matters and legal aid work should be similar to the guidance given in paragraph 36 below.

No rigid rules

31. It is not possible to lay down rigid rules as to what to do. There might be instances where the inclusion of overheads is appropriate even in cases within 29(a) to (c) above. In an extreme example (admittedly unlikely and perhaps contrary to the rules of his or her professional body), if a sole practitioner has only one client but has rendered no fee note to that client during his accounting year, he may need to treat some of the overheads as work-in-progress. However, it must be remembered that overheads would not relate to the work-in-progress to the extent that the office is needed as a base from which to generate new work, carry out marketing or administrative functions such as billing, etc.

32. The Revenue have told the Tax Faculty that Inspectors may wish to understand the basis on which work-in-progress has been calculated but the Revenue would not expect Inspectors to dwell on it, except where it did not

appear to be calculated on a reasonable and consistent basis.

Absence of time records

33. Some professional firms do not maintain time records. For example solicitors and patent agents will often charge a standard fee for a job. In such cases it is not necessary for the taxpayer to introduce time records where he does not need these commercially. Some other method to arrive at a work-in-progress figure will need to be adopted. Where cost details are kept on individual client files a "stocktake" may be possible. Where a "billing exercise" is carried out close to the year end, it may be possible to record details of work not being billed. A review of invoices rendered after the year end may provide a guide to work-in-progress. It may be possible to use statistical techniques to establish the likely number of jobs uncompleted at the year end and an appropriate cost figure.

Valuation: reduction to cost

34. Many professional businesses nowadays record work-in-progress at selling price. It would clearly be conceptually wrong to value it at such a price when computing taxable profits. It is therefore necessary to reduce the book figure at selling price to arrive at the cost of work-in-progress. While there may be 'rules of thumb' which can often provide a reasonable approximation, the individual circumstances need to be considered, and 'rules of thumb' may not always be appropriate.

35. It needs to be remembered that work-in-progress is the figure that the concept of matching requires to be carried forward. But SSAP 2 makes clear that the accruals concept is subservient to the concept of prudence. Among other things this prohibits the carrying forward of current expenditure to the extent that it is not recoverable. If a fixed fee has been quoted for a job the value of work-in-progress will not exceed that fee less the estimated costs

that will need to be incurred to complete the job.

36. As with other judgements, the estimate of the net realisable value of work-in-progress should be made on the basis of the information available at the time the accounts are drawn up (see paragraph 43 onwards). Thus, where work is done on a speculative or contingency basis ("no win, no fee"), but it is clear at the time the accounts are drawn up that the case has been won and that the firm will at least recover its costs, work-in-progress on the contract should be valued at cost. Where, however, the contingency has not been satisfied at that time, so that there is still a reasonable chance that the firm will recover nothing, the net realisable value of work-in-progress is likely to be nil. Paragraph 49 also gives guidance on the recognition of income and contingent fee cases.

Valuation: more complicated cases

37. If the client is in a precarious financial position and unlikely to be able to pay for the work it is equally unlikely that the work-in-progress has any real value. As with stock, it is necessary to consider each item of work-in-progress to confirm that its net realisable value exceeds its costs and, if not, to write it down to that value. In the case of work-in-progress there is normally only one "customer" for the work so the net realisable value will depend on an assessment of what that customer can be expected to pay for it. However, the concept cannot be taken too far. What is needed is not an assessment of what the customer will pay for the work in its current state; the assumption that the work will be completed needs to be made.

38. In some cases it may not be possible to arrive at a value for work-in-progress. *Mason v Innes* (44 TC 326) established that an author cannot have work-in-progress at least before he has entered into a contract with a publisher for the book and the Revenue accept this.

39. The definition of long-term contracts given in SSAP 9 is not easy to follow. The authors of UK GAAP (published by Ernst and Young) express the view that the wording is wide enough to require even uncompleted short contracts to be treated as long-term and comment "This could hardly have been the Standard's intention". They surmise that the crucial factor of the definition is consistency. They also suggest that the distinction that needs to be drawn is between short-term contracting businesses and long-term contracting businesses. A business engaged ordinarily in short-term contracts should normally account for all its contracts on a short-term basis.

40. Most professionals, other than in the construction industry, are unlikely to be involved in long-term contracts. For example the annual audit or accounting work for a client which is billed regularly is in practical terms a series of short-term contracts. Some corporate finance activities such as seeking over an extended period to find a buyer for a business might be long-term. Other examples are prolonged insolvency work in one company's liquidation and prolonged probate work by solicitors in handling a complex estate.

41. The Revenue would not normally seek to challenge whether a job is short-term or long-term where the case is billed periodically and profit recognised on such billing. However, if interim billing, or requests for payment, are held in suspense on the basis that the contract is long-term, and no income or profit is recognised, the Revenue could well challenge the treatment. The key factor is that the treatment should not lead to distortion of the turnover or results for the year.

Examples

42. It was noted in paragraph 31 that it is not possible to lay down rigid guidelines. However, in order to provide further guidance, Annex D sets out five examples

as to how the Faculty considers work-in-progress should be valued and calculated. The examples also highlight the types of problems which will occur in practice and how they may be resolved:

- Example 1 Sole practitioner
- Example 2 Chargeable staff and materiality
- Example 3 Chargeable staff - accounting for work-in-progress
- Example 4 Payments on account
- Example 5 Year end problems

Time at which judgement is to be made

43. The Revenue recognise that preparing accounts to give a true and fair view of profits normally requires an element of judgement (see Annex A). For example someone needs to decide whether the work-in-progress on a particular piece of work should be valued at cost or at net realisable value. Such judgements should be made on the basis of the information available at the date the accounts of the business are approved.

44. Unlike companies (where accounts must be approved by the Board of Directors) unincorporated businesses are not required to follow any formal procedure for approving accounts. The Revenue will accept as the “date of approval” any date on which a procedure recognisably similar to that followed by companies is completed. For small partnerships and sole practices this would be when the proprietors give their approval to the accounts. For larger partnerships there might be a body such as an Executive Committee which approves accounts for submission to a general meeting of partners. The “date of approval” would be the date of approval by the Executive Committee.

45. While there is no requirement for accounts of unincorporated bodies to be signed by or on behalf of those approving them, or to be dated, it may

well be helpful in giving certainty to the date of approval if accounts are signed and dated.

46. SSAP 17 (Accounting for post balance sheet events) requires events arising after the balance sheet date to be taken into account when they provide evidence of conditions existing at that date. In the case of a company the date of approval of the accounts is a convenient cut-off point to review post balance sheet events. Where a partnership has a formal procedure to approve accounts such approval might provide a convenient cut-off point. The Tax Faculty does not believe that where no such procedure exists it is necessary to attempt to identify a cut-off point.

47. The principle is that post balance sheet events need to be taken into account. Where work-in-progress is ascertained some time after the balance sheet date the review undertaken at that time will reflect post balance sheet events up to that time. We do not believe that any subsequent review is needed unless the taxpayer becomes aware of material knowledge that vitiates a decision made at the time the work-in-progress was ascertained. Common sense obviously needs to be used in determining whether subsequent material events are likely to occur after the time of the initial review.

Income recognition and debtors

48. Profit cannot be deferred by leaving jobs in work-in-progress after they have reached a billable stage. Once a job has been completed the billable amount should normally be recognised as a debtor rather than work-in-progress. Where a request for payment is issued under the VAT Continuous Service rules, the issue of that request will normally trigger a requirement to regard the amount as a debtor for accounting purposes.

49. Paragraph 36 above discussed the treatment of contingent events in relation to work-in-progress. In the

case of income recognition, the Revenue have told us that they accept that income need not be recognised for a job which depends on a contingency until that contingency is satisfied. For example, a lawyer who took on a case on a “no win, no fee” basis need not recognise the fee until the case is won; only then is the condition met which is necessary to earn the fee. In addition, the Revenue accept that, for this purpose, it is open to the professional to deal with a large number of similar contingent fee cases either in the aggregate or to look at each one separately. Under the former approach it might be possible to say that a certain percentage will yield a fee and to recognise income accordingly. Under the latter approach there is no certainty that any particular case will yield a fee and so no income need be recognised for any of them until the contingency is satisfied in each case.

50. There is nothing special about valuing debtors of a professional practice: normal practice should be applied. It is as permissible to provide against bad and doubtful debts as in any other business.

Alternative acceptable accounting principles

51. Some accountants are concerned that where there are two or more acceptable approaches to valuing work-in-progress the Inspector of Taxes may take a different view of which method ought to be adopted.

52. It is well enough established that the Revenue do not have the right to substitute one basis which is valid for tax purposes for another such basis. In *Pearce v Woodall-Duckham Ltd* (51 TC 273) for example Templeman J (later Lord Templeman) said: “The company was entitled to produce accounts based on its on-cost method prior to 1969. The company was entitled, but not bound, to produce accounts for 1969 and subsequent years by the accrued profit method. The change was made for sound

commercial reasons". Equally the Revenue's view is that where a basis which is valid for tax purposes has been adopted in a taxpayer's accounts the taxpayer does not have the right to adopt a different basis in computing the profits figure to be entered on his tax return.

53. In *Johnston v Britannia Airways* (67 TC 99) Knox J said: "Which of the three ways in which the attribution of cost to a period or periods of accounting is adopted is, in my view, essentially a matter of accountancy judgement, and I am quite unable to detect any legal basis for excluding any of them". Admittedly in that case the Special Commissioners had expressed a preference for the method actually adopted by the taxpayer, but that was not the basis of their decision.

54. In a recent case *A Firm v Honour* (1997 STC(SCD) 293) the Special Commissioners felt themselves entitled to substitute the Revenue's basis for the taxpayer's, albeit both were bases which accorded with normal accountancy principles. However the Revenue did not argue for this - they argued that the taxpayer's basis anticipated losses and needed to be adjusted as a matter of law to exclude such losses from the taxable profit, which is a different concept. It is understood that this case is going to appeal.

55. The Revenue consider that adjustments may also be needed to reflect other principles laid down by the courts in tax cases, such as the prohibition on anticipating losses. Such decisions were of course formulated in an environment where accountancy evidence was less frequently put before the courts. The Tax Faculty does not necessarily accept the Revenue's view. It believes that the current approach of the courts to accounting principles has created a number of unresolved issues that may have been decided by the Courts at some stage.

Annex A (Para 2)

Draft inspector's Manual guidance on the valuation of professional work-in-progress

(1) This section is intended to give guidance to Inspectors on their approach to enquiries into the valuation of professional work-in-progress for tax purposes.

(2) The valuation of work-in-progress is now of more practical significance following FA 1998. This removed the previous 'cash basis' practices and imposes normal accruals accounting for all Case I and II activities. Such accounts will include appropriate entries for work-in-progress. **However, we do not intend that this change should, of itself, call for substantial further enquiries into work-in-progress valuation.** As the guidance below seeks to explain, valuing work-in-progress is a difficult exercise and there are often no simple, black-and-white 'right' answers. Hence we do not expect enquiries will often yield worthwhile net adjustments where firms and their advisors appear to have adopted reasonable procedures in valuing work-in-progress.

(3) The proper valuation of professional work-in-progress depends on the correct application of accountancy principles to the facts. There are no rules of tax law which override the correct application of accountancy principles unless, exceptionally, the basis of valuation causes a profit or a loss to be anticipated.

(4) This has a number of consequences. The first is that a proper basis of valuation must take into account the particular circumstances of the individual firm. Different firms in what may appear to be the same line of business may properly adopt different bases of valuation if their circumstances are different. For example, Firms A and B may both describe themselves as 'estate agents

and chartered surveyors' but this does not necessarily mean that they must adopt the same basis for valuing work-in-progress. If Firm A does mainly surveying and valuation work and Firm B does mainly property sales then a basis of valuation that is acceptable for A may well not be acceptable for B.

(5) Second, the valuation of work-in-progress requires an element of judgement by those responsible for preparing the business accounts. This means that in many cases there is no one right answer to valuing work-in-progress. Instead there may be a choice of possible bases, any of which might be acceptable. Even when a basis is adopted there may well be room for further exercise of judgement as to how that basis should be applied to the facts each year. It follows that just because an Inspector, properly advised, might have come up with a value of work-in-progress that is different from the one shown in the accounts does not mean that the value in the accounts is wrong or can be disturbed.

(6) Third, the valuation of work-in-progress is affected by the accountancy concept of 'materiality'. This means that there is room for variation in figures provided that the variation is not 'material'. What is 'material' depends on the particular circumstances of the firm. However, in considering what is 'material', it is proper for a firm to take into account the resource effort that the firm has to put into valuation. For any firm there comes a point at which refining the techniques of valuation will not produce a 'material' increase in accuracy. Inspectors may wish to refer to the discussion of 'materiality' published by the Institute of Chartered Accountants in England and Wales (TECH 32/96, published in the annual volume of Accounting Standards).

(7) Fourth, any enquiry into the valuation of work-in-progress is likely to involve not only a thorough fact-finding exercise but also advice from a Revenue accountant. It is most unlikely

that any enquiry can be concluded by applying some simple 'rule'.

(8) Fifth, any Commissioners' hearing on the valuation of work-in-progress is likely to require expert accountancy evidence. It follows that a report under IM5098e to Business Tax Division (Schedule D) must be made before the case is listed for a contentious hearing.

(9) Sixth, the 'Ahmedabad' principle (see IM548a-c) applies to changes in the basis of valuing work-in-progress just as it applies to trading stock, except for work-in-progress included in the 'catching-up' adjustment (see below). This means that where profits for a year are required to show a 'true and fair view', and the closing figure for work-in-progress is adjusted so that they do so, the opening figure for the year must be adjusted on the same basis. So there is usually no question of simply securing an increase in the closing valuation.

(The guidance in this paragraph is merely a brief draft at this stage and more detailed material will be included in the final version.)

Annex B (para 7)

Extract from Inland Revenue March 1998 Budget Press Release IR 29

Use of 'true and fair view'

24. The aim of the proposals is to apply the earnings basis to professionals on the cash and conventional bases. The earnings basis is already the basis which applies under the existing law to some professionals and to traders. We believe the use of the accountancy concept of a 'true and fair view' does the job in a concise yet flexible way because:

1. accounting standards as they currently operate are applied and so the tax treatment can adapt automatically to changes in those standards; and

2. the accountancy concept of 'materiality' is imported, which means a practical view can be taken of the time when immaterial amounts are recognised.

25. The materiality concept is particularly relevant in arriving at work-in-progress. It permits a broad brush approach in small cases or for small amounts. Although there may be occasions where accountancy practice is displaced by a rule of tax law the Inland Revenue do not consider such an approach to materiality in the valuation of work-in-progress, if sanctioned by accountancy practice, to be inconsistent with tax law.

26. The 'true and fair view' approach is concerned only with the computation of taxable profits or losses. For these proposals it:

1. makes no difference to the law under which traders compute business profits;
2. does not require accounts to be drawn up on any particular basis; for example, cash basis accounts could still be prepared provided adjustments are made to convert the profit to an earnings basis profit in the tax computations;
3. does not require accounts to be audited;
4. does not require additional disclosure or require a true and fair view balance sheet to be prepared.

Annex C (Para 14)

Accounting standards and other pronouncements most likely to affect the calculation of the taxable profits of professional businesses

FRSSE (financial reporting standard for smaller entities)

SSAP 2 (disclosure of accounting policies),

SSAP 4 (accounting for government grants),

SSAP 5 (accounting for VAT),

SSAP 9 (stocks and long term contracts),

SSAP 13 (accounting for research and development),

SSAP 17 (accounting for post balance sheet events),

SSAP 18 (accounting for contingencies) - now superseded by FRS 12,

SSAP 20 (foreign currency translation),

SSAP 21 (accounting for leases and HP contracts),

SSAP 22 (accounting for goodwill) - now superseded by FRS 10,

SSAP 24 (accounting for pension costs),

FRS 5 (reporting the substance of transactions),

FRS 10 (goodwill and intangible assets),

FRS 12 (provisions, contingent liabilities and contingent assets),

UITF abstract 3 (treatment of goodwill on disposal) - now superseded by FRS 10,

UITF abstract 5 (transfers from current assets to fixed assets), and ,

UITF abstract 6 (accounting for post-retirement benefits other than pensions).

UITF abstract 12 (lessee accounting for reverse premiums and similar incentives).

TECH 32/96 (the interpretation of materiality) (Reproduced as section 2.401 of Accounting Standards and Guidance for Members).

Annex D (Para 42)

Examples of the valuation of work-in-progress

Example 1. Sole practitioner

John is a sole practitioner. He prepares accounts to 30 April each year. John employs a secretary at a salary of £15,000 pa but he has no other staff. His office rent is £6,000 pa and other overheads average £8,000 pa. In his client's portfolio, has one large client Maximus Ltd on which he uses two sub-contractors, Bill and Ben, each year. They do the bulk of the work in March and April. In March 2001 Bill invoices John for £2,000. Ben bills £3,000 but does not submit his invoice until May 2001. John bills Maximus Ltd £10,000 in May 2001. His agreement with Bill and Ben is that he will not pay them until he is paid by Maximus Ltd.

There is no work-in-progress in relation to John's own time. There will however be work-in-progress in relation to the time of Bill and Ben in respect of work done on Maximus Ltd. This will be the direct cost of their work and will amount to £5,000. It is irrelevant that Ben has not billed John by 30 April. As John has to prepare his accounts on an accruals basis he will accrue for the amounts that he owes Ben but will then carry that expense forward as work-in-progress. If Bill and Ben had not completed their work by 30 April John would only accrue his estimate of the part of their fees that relates to work done to that date. Thus, in Bill's case, John would accrue only for the relevant part of the £2,000 and would then of course carry the same amount forward as work-in-progress.

Example 2. Chargeable staff and materiality

Suppose that John in example 1 had trained his secretary to also do book-keeping work for two clients. She works 35 hours a week for 47 weeks a year (ie 1,645 hours a year). It takes her 5 hours a week to do the bookkeeping work. It is billed monthly in arrears. John charges each of the clients £200 a month for this service.

Although there is no work-in-progress at 30 April 2001 in respect of John's time there will be some in relation to the bookkeeping work. This might be calculated as:

Secretary's salary	£15,000
NI 12.2%	<u>1,830</u>
	<u>£16,830</u>
Cost per hour: £16,830/1,645	£10.23
Work done but not billed for at 30 April 2001	
4 weeks x 5 hours x £10.23 per hour	£205
Work-in-progress	£205

John would probably not include the amount of £205 as work-in-progress because it is not material. Even attaching production overheads to the secretary's cost per hour is unlikely to render the figure material.

Example 3. Chargeable staff - accounting for work-in-progress

Peter and Paul are a two partner firm employing five chargeable staff plus two secretaries. Their profit and loss account shows the following;

	£
Fees	800,000
Salaries, NI and pension contributions professional staff	140,000
secretaries	25,000
Rent and premises	30,000
Other overheads	40,000

Peter and Paul record their work-in-progress at selling price. At 30 April 2001, the work-in-progress was £240,000. On analysis it is found that £105,000 of this is Peter and Paul's time and the rest staff time. An analysis of the fees shows that Peter and Paul have billed £350,000 in relation to their own time and £450,000 in respect of staff time.

There is no work-in-progress in relation to Peter and Paul's own time. There is work-in-progress in relation to staff time. The total of £135,000 (£240,000 less Peter and Paul's time of £105,000) needs to be reduced to cost.

The chargeable staff work a 35 hour week and occupy 40% of the premises. Of the other overheads, Peter and Paul are of the opinion that 50% of these costs are directly related to production.

Two possible methods of arriving at a figure of cost for work-in-progress are as follows.

Method 1

One way to do this would be to use the ratio of the cost of work produced by staff during the year to the market value of that work.

Thus, the calculation is as follows:

$$\frac{(A + B + C) - D}{(E + F) - G} \times \text{Staff work-in-progress at selling cost where:}$$

A = the salaries, NI and pension costs of professional staff - £140,000 in this case.

B = the rent and premises costs attributable to the professional staff - 40% of £30,000 in this case, since they occupy 40% of the premises, ie. £12,000.

C = the proportion of the other overheads attributable to professional staff - 50% of £40,000 in this case

D = the cost of the opening work-in-progress - none in this case.

E = the proportion of the total fees of £800,000 billed in the year attributable to professional staff - £450,000 in this case.

F = the selling price of closing work-in-progress attributable to professional staff - £135,000 in this case.

G = the selling price of the opening work-in-progress attributable to professional staff - none in this example.

The work-in-progress in this example is therefore:

$$\frac{(\pounds 140,000 + \pounds 12,000 + \pounds 20,000) \times \pounds 135,000, \text{ ie}}{(\pounds 450,000 + \pounds 135,000)} \quad \underline{\underline{\pounds 39,692}}$$

NB. In this example, it is assumed for simplicity that there is no opening figure for work-in-progress. If there was opening work-in-progress, it would be necessary (as stated in the formula above) to deduct its opening cost from the numerator and its opening market value from the denominator.

Method 2

Another method would be to identify the hours of staff work-in-progress and multiply this figure by an estimated average staff cost per hour. In the example below, it is assumed that the staff cost per hour for each employee is based upon 1,820 hours, ie. 35 hours x 52 weeks a year. The staff hours of work-in-progress of 2,100 come from the records.

Total staff work-in-progress at selling price	<u>£135,000</u>
Staff hours of work-in-progress	<u>2,100</u>
Average cost of professional staff is:	

Professional staff salaries	
<u>£140,000</u>	£15.38
(5 x 1,820 hours)	

Add: Production overheads	
Rent and premises	
<u>(£30,000 x 40%)</u>	£1.32
(5 x 1,820 hours)	
Other overheads	
<u>(£40,000 x 50%)</u>	<u>£2.20</u>
(5 staff x 1,820 hours)	
Notional hourly cost	<u>£18.90</u>
Value of work-in-progress is:	
2,100 x £18.90	<u>£39,690</u>

There is no single right method to value work-in-progress. In our view, either method should be an acceptable method of valuing work-in-progress.

In practice, the Revenue accept that the materiality concept would not require the inclusion of an overhead loading for such a small firm. The overheads of around £7,400 are not material in relation to the profit of the firm (which is over £550,000). However, the Example includes the overhead calculations by way of illustration.

Example 4. Payments on account

a) Peter and Paul in Example 3 have set up a standing order for one client, Joe Bloggs Ltd who pays them £1,000 a month on account of fees. The main work on the job is done in June.

b) Peter is a little worried about the financial stability of another client, Fred Smith Ltd, and accordingly asked the company for £10,000 on account of the year's fee in April 2001. At that time the work-in-progress on the clock (at selling price) was £8,000 of which £2,000 was Peter's time and the balance staff time.

How should these payments be reflected, if at all, in the calculation of work-in-progress?

a) Payment from Joe Bloggs Ltd

At 30 April 2001 Peter and Paul will have received £10,000 payment (ie: 10 payments of £1,000) from Joe Bloggs Ltd for work not yet done. That would not relate to work-in-progress. It would simply be carried forward in the balance sheet as a creditor as being amounts invoiced in advance.

b) Payment from Fred Smith Ltd

There are two possible ways to deal with the £10,000 from Fred Smith Ltd. Which is correct will depend on the exact transaction with that company. If Peter simply

asked for a cheque the amount received is a creditor in the same way as that from Joe Bloggs Ltd. In addition Peter and Paul will have work-in-progress (calculated as in Example 3) in respect of Fred Smith Ltd of:

$$\frac{(140,000+12,000+20,000)}{(450,000 + 135,000)} \times £(8,000-2,000 \text{ ie minus Peter's time}) = \underline{£1,764}$$

If Peter invoiced the £10,000 as a payment on account Peter and Paul would probably need to recognise at least part of it (ie. £8,000) as income and would then have no work-in-progress in relation to Fred Smith Ltd, and a balance of £2,000 will be handled in the accounts as a creditor on account of work not yet done.

The Revenue may seek to challenge cases where there appears to be an attempt to defer income recognition.

Example 5. Year end problems

When Peter and Paul prepare their accounts to 30 April 2001 they realise they have two problem areas.

a) There is £15,000 time on the clock for M Owner Ltd. Last year's fee was £6,000. Another £2,000 of time will be needed to finish the job. There is no way that M Owner Ltd will accept a bill for £17,000.

b) Peter did not realise that the cheque from Fred Smith Ltd has been dishonoured. A further £6,000 of staff time has been spent and the total time on the clock is now £14,000. Fred Smith's financial problems are now so acute that it will clearly go into liquidation unless Peter spends further time on installing a new accounting system for the company.

a) M Owner Ltd

Peter and Paul will need to assess what they believe M Owner Ltd will pay. Suppose they think it is £8,000. They then analyse the £17,000 of time and discover that £6,000 is Paul's time and £11,000 staff time.

The cost of the staff work-in-progress is then:

$$\frac{(140,000 + 12,000 + 20,000)}{(450,000 + 135,000)} \text{ (per Example 3)} \times £11,000 = £3,234$$

As this is less than net realisable value of the contract the work-in-progress is £3,234

b) Fred Smith Ltd

As far as Fred Smith Ltd is concerned Peter and Paul would probably decide that the likelihood of recovery of any of the staff time is now remote and thus not recognise any work-in-progress in respect of such time at 30 April.

If they think that Peter will need to incur, say, a further £2,000 of time but will then be able to bill and recover both that additional time and the whole of the £14,000 outstanding, the work-in-progress at 30 April will be arrived at as in Example 4.

If they think that Peter will only be able to collect a lesser sum they will need to form a view as to whether or not this will be less than the cost figure in arriving at the work-in-progress at 30 April.

THE NEW CONSTRUCTION INDUSTRY SCHEME: TURNOVER TESTS

The new Construction Industry Scheme will commence on 1 August 1999. From that date all existing exception certificates (714I, P, C & S) issued to subcontractors in the construction industry will become invalid. The legislation governing the new scheme was introduced in the 1995 and 1996 Finance Acts together with some minor amendments in the 1998 Finance Act. The regulations were laid on 23 October 1998.

One of the major changes to the scheme is the introduction of a turnover test as one of the conditions of eligibility for a new gross payment certificate. The regulations contain a turnover threshold for an individual of £30,000 and an alternative threshold for partnerships and companies of £200,000. Our Press Release of 23 October (Construction Industry Tax Scheme: Turnover Test Changes) explained that 'turnover' for all the turnover tests means income, net of the cost of materials, received for construction work, whether carried out within or outside the Scheme.

To pass the turnover test an individual trader needs to have net turnover of at least £30,000 per annum. This 'individual turnover threshold' must be demonstrated either on the basis of:

- a 3 year period, in which the turnover for at least two of the years clears the threshold AND the average turnover over the 3 years meets 90% of the average of the thresholds for those years, or
- a period of six or fewer consecutive tax months in which the turnover is at least 70% of the annual threshold (i.e. 70% x £30,000 = £21,000).

Any period of three consecutive years can be chosen for this test, regardless of the accounting periods. But the three years must be wholly contained within the period of four years ending with the date of the application. In the case of the six month basis the period selected must fall entirely within the twelve months before the application date. A partnership can pass the turnover test by showing that its construction turnover, net of the cost of materials, are at least equivalent to the individual threshold of £30,000 multiplied by the number of partners (the 'multiple partnership turnover threshold'). So, a partnership with four partners would need a turnover of £120,000. It can demonstrate this on the same basis as the individual trader - i.e. over a period of three years or six months, as set out above, with the appropriate threshold for the partnership in place of the individual threshold.

Alternatively the partnership can pass the test by showing that its total income from all construction work is at least £200,000 per annum (the 'alternative partnership turnover threshold'), regardless of the number of partners. However this alternative threshold can only be demonstrated on the basis of the three year period as set out above, because it is aimed at businesses with an established trading history.

The turnover test for companies works on the same principle as for partnerships. The only difference is that, instead of partners, the individual threshold of £30,000 is multiplied by the number of directors and, in the case of a closely-controlled company, by the shareholders too, to arrive at the 'multiple company turnover threshold'. So for a company which has two directors and four shareholders who include those directors, the multiple threshold would be £120,000. The application of the alternative threshold of £200,000 to companies is identical to that for partnerships.

A company is not required to pass the turnover test if its shares are held only by companies which themselves have valid gross payment certificates under the new schemes.

Where a company is a partner, the partnership could use the alternative test outlined above, or it could use the standard multiple partnership test. The multiple partnership turnover threshold is based on the number of partners excluding the company, plus the turnover threshold appropriate to the company. For example, if a partnership has two individuals and one company as partners, and the company has two directors each holding 50% of the share capital, the multiple partnership turnover threshold is

individual partners		
£30,000 x 2 =		£60,000
company directors/shareholders		
£30,000 x 2 =		£ 60,000
multiple partnership turnover threshold =		£120,000

The multiple thresholds are based on the maximum number of partners etc. *at any point* in each year within the test period. Where a company or partnership applies the multiplier test over the three year period, the thresholds are based on the number of partners or directors and shareholders in each of those periods. However, under an Extra-Statutory Concession published on 23 October 1998, where an application for a certificate is made before 1 August 2001 the thresholds for each of the three years can be based on the number of partners or directors and shareholders in the last six months of those three years, if that is preferred.

An example of the multiplier test-

Partnership application made on 1 June 1999.

Accounting period end 30 April: chosen period three years ended 30/4/1999.

Partners A, B and C are in the firm throughout the period.

Partner D is with the firm at the start of the period but leaves on 31/10/1998.

The individual threshold set in regulations for the whole of this period is £30,000.

The construction turnover, net of the cost of materials, is:

y.e. 30/4/1997	£92,000
y.e. 30/4/1998	£95,000
y.e. 30/4/1999	£100,000

The multiple thresholds for each of the years are as follows -

y.e. 30/4/1997	£30,000 x 4 =	£120,000
y.e. 30/4/1998	£30,000 x 4 =	£120,000
y.e. 30/4/1999	£30,000 x 4 =	£120,000

However, concessionally (as the application was made before 1 August 2001) the thresholds for each of the years can be based on the maximum number of partners in the last six months from 1/11/98 - 30/4/99, i.e.

y.e. 30/4/1997	£30,000 x 3 =	£90,000
y.e. 30/4/1998		£90,000
y.e. 30/4/1999		£90,000

The partnership passes these thresholds.

We are issuing further details about the scheme to tax agents. The application forms, due to be sent to known subcontractors in December, will

contain more information about the turnover test. If, however, you have any questions you wish to raise at this point in time, please write to:

David Jayes, Inland Revenue Business & Management Services Division (Subcontractors), 10 Maltravers Street, London WC2R 1LB.

FINANCIAL GLOBAL TRADING

The term “*global trading*” in the financial sector is most frequently applied to businesses that make markets in financial products on a 24-hour basis within different time zones, whether involving different enterprises or branches of a single enterprise. Many of the tax problems presented by businesses of this type are discussed in the 1998 Organisation for Economic Co-operation and Development (OECD) publication, *The Taxation of Global Trading of Financial Instruments*, but some topics - notably the means of rewarding capital provision and the assumption of risk within a highly integrated business - are receiving further OECD consideration. The purpose of this article is to give some interim guidance on these topics in the light of concerns expressed by some practitioners and industry representatives about current uncertainty.

General

The Inland Revenue approach to financial global trading cases is governed by the same domestic and treaty rules for transfer pricing and attribution of profits to permanent establishments as apply for other industries. We concur wholeheartedly with the approach emphasised in the OECD publication that, wherever it proves possible to rely on them, tax authorities and multinational enterprises should use the traditional transaction methods described in the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

However, the 1998 OECD publication also deals with specific problems arising when certain important functions undertaken in the course of a financial global trading business have become highly integrated across international borders. For example, where a trading book is passed from one country to another and traded-off in each place, or where transactions are the product of the integrated and co-operative actions of staff in more than one location, it may not be possible to adequately identify and evaluate the different functions in isolation. In such cases, if the performers of these functions were acting for independent enterprises they might well have agreed to split the profits arising from their activities rather than attempt to price distinct transactions and services between them. It is therefore sometimes necessary and appropriate to employ a profit split approach in measuring the arm’s length reward with which a particular enterprise or permanent establishment should be credited for undertaking certain of its functions in such an integrated business.

A particular function - the provision of capital

Traders in financial products require access to capital to enable them to conduct their trade. In order to assess what the arm’s length reward for the provision of capital to such a trader would be in any given circumstances, it may be helpful to consider the simplest form in which it could be provided by one enterprise for use in the trading activities of another. This would be where a capital-provider enterprise took on, or booked, all the positions and associated risks arising from the trade of the financial enterprise. In this situation, it would be the capital-provider which, in essence, undertook the transactions and to whom the profits from the transactions with counter-parties will accrue. At arm’s length, it is likely that the financial trader would be rewarded with a fee

from the capital-provider, the amount of which would depend on the one hand on the nature of the trading functions it undertook and on the other, the characteristics of the positions taken by the capital-provider as booking company. For example, if the position involved simply the holding of low risk bonds, at arm’s length the fee might be computed in such a way as to leave the capital-provider with the return that would be expected on a holding of assets of that quality, taking into account the functions performed by the trader. Those functions may be similar to those for which independent parties would be rewarded by way of a commission. In such circumstances, the fee might be arrived at by reference to the appropriate comparable arm’s length commission rate.

If, on the other hand, the positions taken by the capital-provider involved highly uncertain returns - for example proprietary positions in volatile markets - the risk to that enterprise’s capital might be such that at arm’s length in determining its acceptable return on capital for such risk, it would demand a reward which would effectively entitle it to a substantial participation in the profits accruing on the positions. Of course, even in such a case it may be that the value of the financial trader’s services because of its expertise in the particular markets, is such that at arm’s length it would itself demand - and be able to secure - a share of the profits rather than simple commission. From the capital-provider’s standpoint that basis for remuneration also serves to give an incentive for the traders to increase overall profitability on the positions. It is thus possible that at arm’s length the financial trader’s fee would be calculated as a share of the trading profits, the level of which would be dependent on the nature of the trading activity and the full extent of the risks assumed by the capital-provider.

Rewarding capital within a single enterprise

Where a financial trader also trades in one or more branches outside its home jurisdiction, the question arises as to the territory to which the reward for the provision of the enterprise’s capital is properly attributable. The Inland Revenue considers that such an enterprise’s capital should not be arbitrarily linked to a particular location, such as the enterprise’s head office or the branch through which the enterprise’s relationship with a third party customer is normally maintained. The reward relating to the enterprise’s capital should rather be attributed to the location where the capital is used by being put at risk. So, for example, where a financial trading enterprise conducts all its trade in branches outside its home jurisdiction, the reward for the use of the enterprise’s capital would be attributable to those branches, not to the home jurisdiction.

In other cases it may be more difficult to judge where capital has been put at risk. For example, when trading (and perhaps closely inter-linked marketing) of a particular financial product or group or products is fully integrated across an enterprise, each location where the trade is conducted may be appropriately rewarded by applying a profit split methodology, by reference to indicators such as the traders’ (or marketers’) respective contributions - measured, for instance, by reference to levels of remuneration/compensation. In some such cases, it may be that the nature of the risks assumed by the traders in each location is so similar that the relative risk assumption is accurately reflected in the respective traders’ contributions. In other cases, however, there may be differences in the levels of the risk assumed by traders in different locations: for example, because there might be a tendency to trade “riskier” products in one location than in another. This might lead to the need to take into account an additional factor in applying the profit split method - a so-

called “risk factor”. The importance of this factor and thus any weighting given to it in the profit split approach would depend on the same considerations as would apply between separate enterprises - ie, the nature of the trading activities and the risks assumed as a result. The business indicators appropriate to measure such a risk factor will depend on the particular business but may include, to the extent that they can be seen to be accurate indicators of relative risk assumption, measures of the initial values of particular transactions, representative figures from internal risk management models or the risk limits assigned to particular trading locations.

Permanent Establishments of Capital Providers

On the above analysis, if a capital-provider has a permanent establishment in a country in which it is not resident, profits arising on the provision of the capital through the permanent establishment will be properly attributable to that permanent establishment. Where capital has been provided to a separate person or enterprise which conducts a financial trade, it is therefore relevant to determine whether a permanent establishment of the capital-provider exists in accordance with Article 5 of the OECD Model Tax Convention by virtue of the trading activity conducted by that person or enterprise.

In this context it will sometimes be necessary to consider whether the trader constitutes an independent agent acting in the ordinary course of its business as such, in order for Article 5(6) to determine that the trader does not constitute a permanent establishment of the capital provider, in accordance with paragraph 37 of the Commentary on Article 5 of the Model Convention. Where the trading enterprise is merely a company employing the traders, who book trades in the name of the capital provider, a permanent establishment of the capital

provider will generally exist. In other cases, the answer to this question will depend on the nature of the trading enterprise’s actions as agent and its economic and legal relationship with the capital provider.

Any questions on this guidance should be directed to:

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SELF ASSESSMENT: THE 31 JANUARY PAYMENT AND FILING DEADLINE, AND AFTER



One of the lessons learned from reviewing the first year of Self Assessment (SA) was that agents needed more information and support to help their clients comply with their tax obligations, particularly around the 31 January return filing and payment deadline. This article sets out the Inland Revenue’s timetable, explains what is being issued to taxpayers, outlines some support being given to agents, and offers some advice to help agents help their clients to meet their tax obligations most efficiently.

The main timetable begins with the issue of statements of account to taxpayers, with the amount to pay on 31 January 1999 and a personalised payslip. Since we estimate we will be issuing over 4 million statements, the process of obtaining the information will begin on Boxing Day, with issue beginning a day or two later. The Revenue aims to have the last statements in the post by 7 January. The date on the statement is the date at which the details were obtained from our computer system

and not the date of issue. The last statements should be with taxpayers by 13 January.

In the same period we will also be issuing perhaps 3.5 million "Final Reminders" to individuals where the final liability for 1997-98 has not yet been established. The form will include a personalised payslip but not the amount. Final Reminders will be issued where the return has not yet been received, or where the return has been received but has not yet been processed. The Revenue is aiming to have the last Final Reminders in the post by 11 January, and they should be with taxpayers by 15 January. The later date of issue is because we need to identify first those taxpayers to whom we can send statements.

In order to assist agents, we will also be issuing details of your clients' statements of account to you. The package for each agent will consist of a cover note, a summary sheet, the details for each individual client, and a small number of blank payslips. The Revenue aims to issue these packages by 11 January. We are sorry this is a little later than the issue of the statements but you will appreciate a very large number of items is being issued in a short space of time, so some phasing is necessary.

The statements will cover the period from April 1998, when agents received the first statement, to the date the latest information was taken from the computer system, shown at the head of the statement. This may not be exactly the same date as for the statements received by your clients, but in the vast majority of cases the information should be the same on both statements. Where the return has already been received and processed the statement will show any balancing payment for 1997-98 and any first payment on account for 1998-99 due on 31 January 1999.

It remains very important that the payslip issued with the statement sent

to your client accompanies any payment, unless you are paying electronically by BACS or CHAPS. The payslips contain encoded personalised details which ensure that the payment is allocated quickly to the right account. If there is any delay your client may receive a further demand for payment in February. We recommend that payment is made by Bank Giro or at the Post Office. These are the most efficient and secure ways of ensuring a payment reaches the correct taxpayer record quickly. If a cheque payment is to be made by post, please send it to the Accounts Office in the envelope provided to your client and accompanied by your client's personalised payslip. Payments should not be sent to the client's Tax Office, though any query about the charges should be raised with that office and not with the Accounts Office.

If you are unable to obtain your client's payslip, you should use one of the blank payslips in the package or obtain a blank payslip from the Tax Office. Do not use one client's payslip for another client, or take a photocopy of a client's payslip to use for other clients. On the blank payslip please ensure that your client's reference (the 10 digit taxpayer reference, not the National Insurance Number), client's name and the amount of the payment are clearly entered. The payment and payslip should be sent to the Accounts Office at the address indicated on the payslip counterfoil. We would however emphasise that this is very much second best. We are still looking at what steps we can take in future to get personalised payslips directly into the hands of agents.

Where payments are sent to the Accounts Office problems are best avoided by having a single cheque and a single payslip. Where composite payments for more than one taxpayer are made on a single cheque, please ensure there is a separate personalised payslip for each taxpayer and that the individual amounts for each taxpayer add up to the total of the cheque. If

there is any problem in reconciliation this will delay the updating of the records for all the taxpayers concerned.

Turning to the filing of the return, the Final Reminder also reminds taxpayers about the need to send in the return. Please note that the Reminder will include this message where we have received but not processed the return. A Final Reminder will also be issued for the partnership return where appropriate.

Clarification regarding incomplete figures and the use of provisional figures was given in the October Tax Bulletin (pages 593-596). 31 January falls on a Sunday in 1999. It is the responsibility of the taxpayer to ensure that the return is received by the deadline. Returns will be treated as meeting the deadline if they are in the Tax Office post box at the start of business on the morning of Monday 1 February, or if they are delivered in the post on that day. Any return handed in by a taxpayer or agent during the day will be treated as not meeting the deadline.

Obviously we would strongly recommend that wherever possible agents do not rely on last minute compliance, with the risk of missing the deadline and of having the self assessment revised when the return is processed. Spreading the workload of preparing and sending returns by agents, and of processing them by Tax Offices is obviously beneficial to both sides, and is more likely to avoid problems. Those who have joined the Electronic Lodgement Service will of course be able to make use of it for quick transmission and acknowledgement. While it is now too late to join the service to transmit 1998-99 returns unless you have already started the process, you may want to consider this for next year.

Returns can be accepted by any Tax Office but we strongly recommend that the return is sent back to the issuing office. This will avoid any potential

difficulties in recording the return as received and in sending it internally between offices.

Turning to February 1999, we are aiming to start issuing statements from 11 February and continuing till 22 February, to allow reasonable time for the allocation of payments to taxpayer records. Where the return has been processed the statement will be issued to show any charges and any payment. Where the return has not yet been processed but payment has been received (and there is no earlier debt outstanding) the statement will be issued in a subsequent month, when charge and payment can be brought together.

Filing penalties will be issued during the period 23 February to 25 February, to allow good time to ensure that all returns received by the filing deadline have been recorded on the system.

Last year, details about your clients' position were issued in February, mainly to help agents ensure that surcharge was not incurred unnecessarily. Those details will not be issued in February 1999. They are effectively replaced by the issue of the client statements in January 1999. There will be a further issue of client statements in April or early May to bring the position up to date following the processing of returns and payments.

interpretations

OFFSHORE TRUSTS: CAPITAL GAINS TAX: FINANCE ACT 1998

Finance Act 1998: Definition of "protected settlement" in new sub-paragraphs 9(10A)-(10D) of Schedule 5, Taxation of Chargeable Gains Act (TCGA) 1992.

Section 132 of Finance Act 1998 brought trusts set up before 19 March 1991 within the scope of a capital gains tax charge, under Section

86, TCGA 1992, on the settlor of the trust in respect of gains realised by the trust where the settlor, members of the settlor's immediate family, or companies they controlled, could benefit from the trust. For this purpose, "members of the settlor's immediate family" are the settlor's spouse, children of the settlor or of the settlor's spouse and their spouses. Section 132, FA 1998 applies, generally, to chargeable gains realised on or after 6 April 1999.

A category of "protected settlements" will remain outside the scope of the charge on the settlor under Section 86, TCGA 1992. "Protected settlements" are defined at new sub-paragraphs 9(10A) - 9(10D) of Schedule 5, TCGA 1992 as untainted pre-19 March 1991 settlements where the only members of the settlor's immediate family who can benefit from the trust are, broadly:

- unborn children of the settlor or of the settlor's (current or future) spouse, or
- such children who are under the age of 18 at the end of the immediately preceding year of assessment. Future spouses of such children or of the settlor can also be included without jeopardising the "protected settlement" status, as can persons who are not counted as members of the settlor's immediate family for the purposes of the settlor charge.

However, Section 131, FA 1998 treats grandchildren of the settlor or of the settlor's spouse as members of the settlor's immediate family for the purposes of the settlor charge in relation to trusts set up on or after 17 March 1998, or trusts set up before that date which become tainted. There is therefore some question over whether pre-1991 trusts where the beneficiaries, at 6 April 1999, include both children under 18 and grandchildren as the only members of the settlor's immediate family who can benefit from the trust would meet the definition of a "protected settlement".

In such cases the Inland Revenue will not regard the existence of the settlor's (or the settlor's spouse's) grandchildren of whatever age as beneficiaries of a relevant settlement as causing the settlement to fall outside the definition of a "protected settlement" for the purposes of new paragraphs 9(10A)-9(10D), Schedule 5, TCGA 1992.

miscellaneous

REVENUE PROSECUTIONS

The Inland Revenue has a policy of selective prosecution involving the most serious cases across the whole range of the tax system. The Board sees this as an important part of its strategy to deter tax fraud and evasion. As part of the wider publicity for this strategy, details of Revenue prosecutions are published in Tax Bulletin.

Recent convictions include:

William Michael Gallagher

Mr Gallagher, a construction industry gangmaster from Harrow, was recently sentenced to two years imprisonment. He illegally used Inland Revenue sub-contractors' certificates and vouchers to obtain untaxed payments from contractors totalling over £9 million. £2.25 million tax would have been due, along with some £1.6 million VAT. The case was the result of a successful joint operation between the Inland Revenue and Customs & Excise.

Peter Ronald Baker

Mr Baker was a window cleaner from Reading. Following an Inland Revenue investigation he was sentenced to 12 months imprisonment for tax fraud on each of 18 offences to run concurrently. A confiscation order of £114,734 was also made against him. This case received widespread press coverage.

Raymond John Blundell

This restaurant owner from Middlesex was jailed for 4 years and ordered to pay £401,498 within 18 months. It was

alleged that he cheated the Revenue by paying wages without the proper deduction of tax and NIC. He pleaded guilty to a charge of cheat contrary to common law and to a VAT charge. The tax loss was estimated at £439,189.

Roy Rollinson

Mr Rollinson, a builder from Cleveland, was sentenced to 15 months imprisonment at Teesside Crown Court on 14 September after pleading guilty to seven counts of common law cheat. He had denied that he was in business and had failed to declare his income to the Inland Revenue. He did not pay the tax that was due on his profits and did not deduct and hand over tax from the people he engaged. The total tax lost was £27,000.

Abdul Hye Choudhury

Mr Choudhury traded from The Curry Centre restaurant in Sheffield. He submitted accounts for 4 years which understated his turnover and profits. He also gave false information about his assets including several bank accounts in Bangladesh. These were not initially disclosed but their existence was revealed by the Revenue's enquiries. The tax loss was estimated at up to £75,000. He pleaded guilty at Sheffield Crown Court to 4 charges of cheating the public revenue and was jailed for 18 months.

PENSION SCHEMES OFFICE

SYNOPSIS OF UPDATES

The Pension Schemes Office (PSO) has issued a further five Updates to all customers on the PSO Mailing List. Updates No 45 to 47 were issued on 24 July and Updates No 48 and 49 on 24 August.

Update No 45 advises of the coming into force of a set of Regulations which further amend the "1991 Small Self-administered Scheme Regulations" (SI 1991/1614). The amendments make it clear that, in relation to sums borrowed to purchase assets, it is only such sums

as are actually outstanding at the relevant time that need to be taken into account. They also make provision for a pensioner trustee's appointment to be terminated in certain specific circumstances. The Update also announces a revised and amended version of part 5 of the Inland Revenue "Model Rules" to reflect the amendments brought about by the new Regulations and describes the procedure for incorporating the changes into the rules of small self-administered schemes.

Update No 46 is about customer service matters. It provides feedback on the results of last year's customer surveys and advises what the PSO intends to do to improve certain areas where results were not as good as the Office would have liked. The Update also advises of the availability of the PSO Operating Plan for the year 1998-99 and gives advance notification of the publication, in August, of a revised version of the customer service leaflet 'You and the Pension Schemes Office'.

Update No 47 is concerned with three things. First it describes the changes which have been made to the various PSO application forms as a result of provisions in the 1998 Finance Bill (enacted on 31 July 1998) and advises of an easement for the submission of applications for approval to facilitate the change to the new forms. Secondly, it advises on changes to various forms as a result of the provisions of the Information Powers Regulations, in particular the easement to allow a third party to sign on behalf of the scheme administrator subject to written authority having been given. Thirdly, in order to counter abuse it has been necessary to amend the de minimis limit set out in the Guidance Notes entitled "Maximum Permissible Funding Rates for Small Self-administered Schemes (SSASs)(SSAS 1996 Method)".

Update No 48 covers the following :

- Clarification of the position in relation to certain aspects of SSAS investments.
- Amendment of the forms PS 7012 to PS 7015 which are used for reporting particular SSAS investments.
- An amendment to paragraph 8.27 of the 'Practice Notes' IR12 (1997) to make it clear that, with effect from the date of this Update, the £100,000 limit on final remuneration for the purposes of calculating lump sum benefits for pre-1 June 1989 continued rights members is applicable only to items D and E of the formula in PN 8.25.
- Advises corrections to two errors which occurred in previous Updates.
- Advises of the issue of the revised version of the PSO customer service leaflet IR 120, as promised in Update No 46.

Update No 49 provides guidance for the trustees of tax approved occupational pension schemes on the issue and completion of the self assessment tax return for 1997-98 and 1998-99. It also clarifies the meaning of the expression "a change of job" in the various forms used to report transfers to overseas schemes.

CORPORATION TAX:

QUARTERLY INSTALMENT

PAYMENTS

There is an error in the new leaflet, "A Modern System for Corporation Tax Payments - A Guide to Quarterly Instalment Payments". On Page 9, in the interest example in the second bullet which starts "From 14 July", references to "14 July" should read "14 October".

Inland Revenue Statements of Practice and Extra-Statutory Concessions issued between 1 October and 30 November 1998

Extra Statutory Concessions

Number	Title	Date of Issue
B51	Subcontractors in the construction industry: the turnover test-definition of "turnover"	23/10/98
B52	Subcontractors in the construction industry: the multiple turnover test	23/10/98

Statement of Practice

03/98	Stamp duty: group relief	13/10/98
04/98	Application of loan relationships, foreign exchange and financial instruments legislation to partnerships which include companies	16/11/98

You can get copies of SPs and ESCs from Christine Jordan at the Inland Revenue Information Centre, Ground Floor, South West Wing, Bush House, Strand, London WC2B 4RD. Telephone 0171 438 7772.

CONTENT

The content of Tax Bulletin gives the views of our technical specialists on particular issues. The information published is reported because it may be of interest to tax practitioners. Publication will be six times a year, and include a cumulative index on an annual basis.

- You can expect that interpretations of the law contained in the Bulletin will normally be applied in relevant cases, but this is subject to a number of qualifications.
- Particular cases may turn on their own facts, or context, and because every possible situation cannot be covered, there may be circumstances in which the interpretation given here will not apply.
- There may also be circumstances in which the Board would find it necessary to argue for a different interpretation in appeal proceedings.
- The Bulletin does not replace formal Statements of Practice.
- The Board's view of the law may change in the future. Readers will be notified of any changes in future editions.

Nothing in this Bulletin affects a taxpayer's right of appeal on any point.

Letters on any article appearing in Tax Bulletin should be sent to the Editor, Jeremy Sherwood, Room 402, 22 Kingsway, London WC2B 6NR. We are sorry though that neither he nor our contributors will normally be able to enter into correspondence about Tax Bulletin or its contents.

SUBSCRIPTION

The subscription for 1998 is £20. If you would like to subscribe to Tax Bulletin please send your name and address together with your cheque to Inland Revenue, Finance Division, Barrington Road, Worthing, West Sussex BN12 4XH. Cheques should be crossed and made payable to "Inland Revenue".

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