



High-Risk Areas of the Tax Code: Relief for income tax losses

Summary of Responses
July 2012

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1. Introduction

Background

- 1.1. At the 2011 Budget, the Government published “*Tackling Tax Avoidance*”¹ setting out Her Majesty’s Revenue & Customs (HMRC) anti-avoidance strategy. The strategy focuses on preventing tax avoidance to protect the Exchequer and increase certainty for taxpayers. At the same time, the Government also announced a number of specific measures for improving legislative defences against avoidance.
- 1.2. On 30 June 2011, HMRC published a consultation document “*High-Risk Areas of the Tax Code: Relief for income tax losses*” on options to deter tax avoidance exploiting income tax loss reliefs.

Consultation

- 1.3. The consultation on relief for income tax losses ran for a period of 12 weeks, closing on 30 September 2011.
- 1.4. HMRC received 24 written and email responses in total: three from individual tax advisers; three from law and other professional firms; seven from representative bodies; and eleven from firms of tax advisers and accountants. A list of respondents to the consultation is contained at Annex A.
- 1.5. HMRC is grateful to those parties who took the time and trouble to respond.

Aim of consultation and responses

- 1.6. The aim of the consultation was to see if a legislative approach could be found that would deter avoidance that exploits income tax loss reliefs whilst ensuring that adverse consequences are minimised for businesses with genuine losses. The consultation covered specific income tax loss reliefs that can be set against a person’s income or gains of the same tax year or another tax year, the main focus being on trade loss reliefs available for set-off against general income and gains, property loss relief available for set-off against general income, and employment losses.
- 1.7. The need for clearer and more effective legislation arises because significant numbers of individuals continue to enter into avoidance arrangements intended to reduce or eliminate their tax liability despite the fact that the outcome sought

¹ *Tackling Tax Avoidance* http://cdn.hm-treasury.gov.uk/2011budget_taxavoidance.pdf

is countered by existing legislation. This creates uncertainty for the taxpayer, places additional demands on HMRC resources and judicial capacity, and puts at risk substantial amounts of tax.

- 1.8. The consultation proposed three options to counter this behaviour:
- a principle-based approach;
 - a mechanistic approach of limiting relief to £25,000; and
 - an administrative approach of withholding repayment where the total loss relief claimed for set-off in a year is in excess of £25,000, until claims have been agreed by HMRC.

Recent developments

- 1.9. At the 2012 Budget the Government announced a cap on uncapped income tax reliefs, to be introduced in April 2013. Although this is not an anti-avoidance measure, it will affect the amounts of loss relief that may be claimed against general income and as such can be expected to impact on avoidance behaviours. The relief cap will include those loss reliefs covered in the Budget 2011 consultation.
- 1.10. A consultation document seeking views on the operation of the relief cap, "*Delivering a cap on income tax reliefs: a technical consultation*", has been published on the HMT website.
- 1.11. The Government also announced proposals for a General Anti-Abuse Rule (GAAR) to be introduced in 2013, following consultation. The proposed GAAR is targeted at artificial and abusive tax avoidance schemes, and is likely to affect at least some of the schemes that seek to exploit loss reliefs against general income and gains. The GAAR consultation was published on 12 June 2012.
- 1.12. Since the consultation was completed the Government has also announced that targeted anti-avoidance rules will be introduced in Finance Bill 2012 for property loss relief with an agricultural connection and post-cessation trade and property reliefs.
- 1.13. As these policy changes significantly impact on income tax loss reliefs the Government has decided that HMRC will monitor the effect of these developments before considering whether further action is needed against avoidance involving income tax loss reliefs.

2. Responses

2.1 This chapter summarises the responses received during the consultation generally, and specifically in relation to each of the questions and the three options proposed.

General

2.2 Many respondents considered that there was sufficient power within the existing legal framework to prevent avoidance involving claims to loss reliefs from succeeding. Others questioned whether there was a problem at all.

2.3 One respondent welcomed the fact that the consultation proposed that “sideways loss relief” should be retained rather than abolished altogether.

2.4 Those arguing that no change to the legislation was needed thought that:

- the current legislation is sufficient and HMRC should investigate and litigate more;
- the recent decision in the case of Commissioners for Her Majesty’s Revenue and Customs v Tower MCashback LLP¹ and another (Tower MCashback)² addresses the notional/circular finance issues;
- where deception and concealment are present, current penalties if applied more often would act as a deterrent.

2.5 One respondent suggested that the proposed restriction of relief to £25,000 would sanction avoidance in claims up to this level.

The questions

Trade loss reliefs

Question 1: HMRC would welcome comments on ways to deter the making of invalid claims to “sideways loss relief”.

2.6 The suggestions made were:

- codify current restrictions to make existing legislation more accessible;
- rigorously investigate and use the entire range of existing legal remedies;

² [2011] STC 1143.

- if invalid claims are predominantly restricted to newly formed trades then these businesses should be the only ones targeted.

2.7 One respondent commented that the “very fact that someone had enough income against which to offset large losses is a strong indicator that they are not heavily involved in the loss-making business”.

Property loss relief

2.8 Many responses focussed solely on the potential effect on the property sector specifically in relation to claims for Business Premises Renovation Allowance (BPRA). In all, 43% of respondents took the view that BPRA should be excluded from any restriction as the proposed options were seen as counter to the intention behind BPRA to incentivise investment in deprived areas.

2.9 A few responses mentioned the interaction with annual investment allowances (AIA).

2.10 Some respondents thought that the Supreme Court decision in the recent case of Tower MCashback would be sufficient to deter artificial financing arrangements in property investments.

2.11 Some respondents observed that a typical average syndicate investment in a property development is £100,000 and were a cap to be introduced at the £25,000 level it would render the developments impracticable.

Question 2: HMRC would welcome comments on ways to deter the making of invalid claims to property loss relief against general income.

2.12 Most comments on property loss relief focussed on the need to retain full relief for BPRA expenditure at the time the expenditure is incurred.

2.13 There were nine responses to this question of which most thought that no change to legislation was necessary or desirable. Suggestions for deterring invalid claims were:

- change the Disclosure of Tax Avoidance Schemes Regulations (DOTAS) to require disclosure of each property plan;
- impose tax-gear penalties in cases of deliberate misrepresentation or concealment;
- provide clear, detailed and regularly updated guidance.

Employment loss relief

2.14 Only four substantive responses on employment loss relief were received.

2.15 One respondent said: “I have always had grave doubts about losses in employment and the fact that a number of schemes were launched using these losses.”

Question 3: HMRC would welcome information on the types of employment and office holder losses that arise and how the relief could be better targeted to these.

2.16 The types of loss mentioned were:

- Losses on repayment of sums previously provided to employee (including claw-back of maternity payments and conditional payments)
- Uninsured Director losses

2.17 The only alternative suggestion was to limit relief to the amounts actually paid rather than those merely accrued.

The Options

Option 1

Question 4: Would restricting loss relief to the amount of the economic loss irrevocably suffered be effective in deterring tax avoidance and provide sufficient certainty? How could it be expressed clearly? Are there alternative principle-based options which should be considered?

2.18 Some respondents agreed in principle with the proposal to restrict loss relief to the amount of economic (or genuine) loss suffered. However, it was thought that this option would only succeed if it could be made sufficiently objective to work in practice. One respondent said that principles are “notoriously difficult to pin down in legislation”. The notion of “irrevocable loss” was seen as a problem as were valuation issues and trying to define “economic loss”.

2.19 The major concern was that capital allowances should be excluded from an “economic loss” principle. It was pointed out that, for example, BPPA is not based on a loss but rather on a quantum of expenditure.

2.20 A common view was that a principle-based approach would lead to complex legislation and create uncertainty.

- 2.21 Several respondents thought that a General Anti-Avoidance Rule (GAAR) should achieve the same outcome and suggested awaiting the outcome of the GAAR study. Since then the Aaronson Study Group has reported and the Government has published a consultation on a General Anti-Abuse Rule.
- 2.22 One respondent expressed the view that “the decision in Tower MCashback has given considerable power to go to the root of what is expended and apply a purposive construction to legislation.”
- 2.23 No alternative principle-based options were suggested.

Option 2

Question 5: What would be the advantages and disadvantages of applying a £25,000 cap for a tax year on total losses that can be relieved against general income or capital gains as “sideways loss relief”, property loss relief against general income, post-cessation trade relief, post-cessation property relief and employment loss relief? Are there alternative mechanistic options which should be considered?

- 2.24 One respondent strongly disagreed with this option and saw it as penalising genuine businesses. Others saw the £25,000 cap as an arbitrary amount. One comment was that this option appeared to sanction avoidance. Some respondents appear to have viewed this option as denying any relief for the whole of a loss that exceeds £25,000 rather than limiting the amount of sideways relief to £25,000.
- 2.25 The advantages of a general £25,000 cap were seen as:
- easy to understand;
 - making tax avoidance uneconomic;
 - providing certainty, especially compared to a principle-based approach; and
 - having a significant deterrent effect on tax avoidance.
- 2.26 The disadvantages were seen as:
- deterring the establishment of new businesses;
 - penalising legitimate claimants; large losses can be made in the early years of a business;
 - the discriminatory nature of providing different results for individuals whose affairs are substantially the same;
 - unfairness, as there is no cap on loss relief for corporates;
 - the restriction of the benefit of BPRA and environmental capital allowances to the very wealthiest in this country; and
 - making it difficult to market future BPRA schemes with this limit in place.

- 2.27 Alternative options suggested included capping allowances in the areas where allowances are abused, an advance clearance regime and an overall cap (significantly higher than £25,000) applying for a rolling period of tax years.

Option 3

Question 6: What would be the advantages and disadvantages of a check first repay later approach being applied where total losses claimed in a tax year as “sideways loss relief”, property loss relief against general income, post-cessation trade relief, post-cessation property relief and employment loss relief exceed £25,000? Are there alternative operational options which should be considered?

- 2.28 This option proposed that, where the total loss relief claimed for a tax year exceeds £25,000, claims would not be repaid or set off until agreed by HMRC. It did not propose, as some respondents thought, that only the excess above £25,000 would be withheld.
- 2.29 Most respondents slightly preferred this option but subject to its being adequately resourced. It was thought to “effectively remove any financial/cash flow benefit from tax avoidance arrangements” and to be the only option that “does not assume that sideways loss relief is a form of tax avoidance.”
- 2.30 However, many respondents doubted HMRC’s ability to provide sufficient resource to deal with claims expeditiously.
- 2.31 There were also concerns expressed by many respondents that this approach goes against the fundamental principles of Self-Assessment.

Taxes Impact Assessment

Question 7: HMRC would welcome comments or evidence to support the assessment of the impacts of the changes under consultation.

- 2.32 There were 10 responses to this question.
- 2.33 Two respondents thought that the statement that “no significant economic impact is anticipated as a result of the options being explored” was untrue or only true in the short term. It was thought that if any of the options resulted in reduced investment there would be an adverse effect on the UK economy and employment. One respondent felt that the impact must depend on the extent to which tax repayments are used to support the business.

2.34 Other respondents thought that the Tax Impact Assessment was devoid of any financial or other data and so was practically meaningless

3. HMRC comment on responses

General

- 3.1 HMRC's view, in line with that of many respondents, is that existing legislation should deal with the majority of known tax avoidance schemes exploiting loss relief.
- 3.2 However, despite that analysis, individuals are continuing to enter into avoidance arrangements intended to reduce or eliminate their tax liability in these ways, leading to significant resource costs for HMRC and taxpayers and considerable burden on the judicial process.
- 3.3 There is evidence of avoidance that exploits these reliefs. The evidence available at the time of publication on 30 June 2011 suggested that avoidance was almost entirely limited to claims in excess of £25,000. The 2008/09 data indicated that over 90% of all claims for reliefs covered by this consultation were for sums below £25,000.
- 3.4 HMRC have calculated that, for claims below £25,000, tax avoidance is generally not economically attractive. This is because the tax benefit is little or no more than the fees payable to the tax avoidance scheme promoter. Nothing in the responses to the consultation countered this view. Two of the options put forward in the consultation were therefore based on the assumption that a cap of £25,000 would have no effect on at least 90% of claims (which are unlikely to involve tax avoidance) and would only affect the small percentage of genuine claims above this cap.
- 3.5 A number of respondents suggested that the current legislation is sufficient and HMRC should rigorously investigate, litigate more and use its entire range of existing legal remedies. HMRC already have in place a compliance programme, targeted appropriately to the risks involved. However, this is resource-intensive, and one of the aims of the consultation was to identify possible ways to deter avoidance schemes at the outset.
- 3.6 Several respondents thought that penalties should be applied. HMRC consider all cases according to their own circumstances. The key issue when considering penalties in circumstances where taxpayers have submitted incorrect returns is whether there is evidence that taxpayers have been careless or deliberate in submitting the incorrect information.
- 3.7 A number of respondents thought the Tower MCashback decision would prove a significant deterrent. One respondent said "the decision in Tower MCashback has given considerable power to go to the root of what is expended and apply a purposive construction to legislation." However, HMRC are already seeing evidence that schemes are being promoted that purportedly sidestep the Tower MCashback decision. This suggests that scheme promoters and users do not necessarily see that decision as a deterrent.

- 3.8 One view was that if avoidance is predominantly restricted to newly formed businesses then it is only new businesses which should be targeted. However, although it may be the case that tax avoiders exploiting these reliefs currently favour new business models, there is a strong risk that avoiders would take steps to circumvent the restriction if it were limited in scope. HMRC do not consider that this suggestion will resolve the fundamental problem of avoidance.
- 3.9 Two respondents expressed concern that any restriction would deny the intended benefit of annual investment allowances (AIA).
- 3.10 As noted above (paragraphs 1.9 - 1.11) future work in this area will be affected by the limit on uncapped reliefs and the proposed GAAR.

The options

Option 1 - the principle that there is no claim to relief unless the loss is a genuine (economic) loss

- 3.11 A common view was that a principle-based approach would lead to complex legislation and create uncertainty. Whilst agreeing that a principle-based approach is not an easy option, HMRC do not agree that either complexity or uncertainty is necessarily inevitable.
- 3.12 The major concern was that capital allowances should be excluded from an “economic loss” principle. It was also pointed out that BPRA is not based on a loss but rather on a quantum of expenditure. Another concern was that it would be difficult to articulate the principle sufficiently clearly. Some respondents thought that ‘economic loss’ would need to be defined in a satisfactory manner.
- 3.13 HMRC will consider how these points might be addressed if legislation is required in the future.

Option 2 - the restriction of loss relief to £25,000

- 3.14 A common response to this option was that the absence of the availability of full, early loss relief against other income or gains would deter people from starting new businesses. HMRC’s analysis of the amounts of losses claimed suggested that few genuine start-up businesses were likely to be affected.
- 3.15 The £25,000 cap was seen by some as an arbitrary amount. The proposed cap mirrors the existing caps on “sideways loss relief” for non-active traders and limited partners in trades, and is set at an amount that strikes a balance between allowing full relief in the majority of cases while targeting anti-avoidance at levels where it is likely to be economic for the avoider.

- 3.16 It was suggested that a restriction to £25,000 would sanction avoidance in claims up to this level. HMRC's analysis suggests that entering into structured avoidance is not generally economic for claims for losses below £25,000. HMRC will nonetheless continue to investigate and, where appropriate, litigate avoidance in cases involving claims under £25,000.
- 3.17 One respondent said that it was unfair to restrict loss relief "in year" as there is no equivalent cap on loss relief for corporates. The income tax and corporation tax regimes are not directly comparable and different approaches are required to counter different forms of avoidance in the most effective manner.
- 3.18 Some respondents appear to have viewed this option as denying any relief for the whole of a loss that exceeds £25,000. That is not the case. This proposal would only affect the amount of losses that could be allowed against general income or gains. Any unused balance would be available for carry forward against future profits of the same business
- 3.19 One respondent suggested a rolling cap, significantly higher than £25,000 applying for a rolling period of a number of tax years. For example, it was suggested that losses would be eligible for sideways relief unless the aggregate amount claimed in the preceding tax year exceeded a stated cap. HMRC's view is that this would add extra complexity and could be vulnerable to manipulation.
- 3.20 Many respondents (58%) took the view that BPRA should be excluded from any restriction as the proposed options were seen as counter to the intention behind BPRA to incentivise investment in deprived areas. A few responses also mentioned the interaction with annual investment allowances (AIA). HMRC recognise that the imposition of a cap on property loss relief would impact on BPRA.
- 3.21 One suggestion for deterring invalid claims was to change the DOTAS rules to require disclosure of each property plan. The DOTAS regime has proved to be valuable in alerting HMRC to avoidance schemes, but disclosure under DOTAS does not of itself counter avoidance. Its role is to alert HMRC to the scheme thus facilitating early action to counter the scheme if appropriate.
- 3.22 The impact of the proposed limit on uncapped income tax relief announced at Budget 2012 needs to be taken into account when considering whether further measures are needed. HMRC intends to monitor the position.

Option 3 - Withholding repayment where total loss relief claimed for a tax year exceeds £25,000 until HMRC agrees the claims

- 3.23 The over-riding objection to this option was that it appeared to be incompatible with the central principles of self assessment.
- 3.24 Several respondents thought that this kind of approach would need significant HMRC resource and that time constraints would need to be placed on HMRC to ensure genuine repayments were released as soon as possible.

- 3.25 A number of respondents suggested that HMRC should introduce a clearance system. However, this is neither appropriate nor practical. The form of avoidance under consideration is complex and necessitates investigation, often taking considerable time. Introducing a clearance regime would mean that all necessary analysis would have to be completed to a compressed timescale.
- 3.26 There was also a view that taxpayers' perception is likely to be that paying unresolved taxes is a tacit admission of eventual liability. HMRC accept that there may be some truth in this as regards genuine claimants but consider that such claimants would obtain repayment quickly. The advantage would be to accelerate tax collection in avoidance cases where a repayment would ultimately not be due.

Consultation data

- 3.27 HMRC accept that the data included in the consultation document was limited. However, it was the most complete and up-to-date data available at the time.

4. Next steps

- 4.1 This consultation generated many thoughtful, informative and constructive responses.
- 4.2 In view of the policy developments mentioned in paragraphs 1.9 – 1.11 the Government has decided that HMRC will monitor the effect of these developments before considering whether further action is needed against avoidance involving income tax loss reliefs.

Annexe A: List of respondents*

AAT
AIMS Accountants for business
Ashursts
B & M Tax Accountants
CB Richard Ellis
CIOT
Deloitte
Downing
Ernst & Young
Grant Thornton
Cannock Investments
Harcourt Capital
ICAEW
Icebreaker
Law Society
Law Society of Scotland
London Society of Chartered Accountants
Matrix
National Farmers Union
PWC
S J Berwin

*Those responding on an individual basis have not been listed.