The Chartered Tax Adviser Examination

November 2017

Application and Interaction
Question 4 - Human Capital

Suggested Solutions

Requirement 1

Report to Karen James, CFO, Fresh Air Ltd regarding income tax and NIC considerations connected with the acquisition of Air Frais SARL

Executive Summary

We have reviewed the information provided and have identified various issues.

The cash payments made to Jennifer Green have created a PAYE and NIC underpayment for the company of circa £42,000 plus potential interest and penalties of approximately £15,000. We recommend that you engage us to assist you in disclosing these underpayments to HMRC as soon as possible.

We also suggest you engage us to prepare Jennifer Green's Self-Assessment income tax returns for all affected years to ensure that any beneficial claims are made and that all aspects of her international travel are reported accurately.

We have reviewed the proposed future travel arrangements for Jennifer. There are cost implications for the company as the accommodation would be UK taxable employment income.

The attendance of the French staff at the planned launch event will not have any UK income tax or NIC consequences. However, we have identified that there will be some additional tax cost in relation to the UK staff. We would recommend entering into a PAYE settlement agreement. We would be happy to assist you in negotiating this with HMRC.

Further detail on all these matters is in the report below.

The scope of our comments is limited to the UK income tax and NIC implications of the matters raised. We recommend that you engage relevant specialists to review the corporation tax and VAT implications of Jennifer Green's activities in France and the contracting arrangements between Fresh Air Ltd and Air Frais SARL.

We also recommend that you seek French tax advice.

Failure to withhold PAYE and NIC on cash allowances paid to Jennifer Green

Quantifying PAYE/NIC failure

The £4,000 per month paid to Jennifer Green throughout 2017 should have been subject to PAYE and NIC withholding.

It is likely that HMRC would consider that the £4,000 per month received by Jennifer as net of any employee income tax and NIC due.

Per my calculations you have underpaid income tax and NIC by £11,545 for 16/17 and £30,786 for 17/18. (Appendix 1)

I have assumed that Jennifer Green is a higher rate taxpayer and that the November payment will be made before you are able to put our recommendations in place.

I have calculated the underpayments on the basis that NIC is due on the whole £4,000 payment. If you have evidence that certain amounts were intended to cover specific tax deductible business expenses we may be able to consider that the portion of the payments on which NIC is due is reduced by this amount. If you believe this to be the case please provide copies of any internal documentation detailing how the figure of £4,000 a month was reached.

Rectifying PAYE/NIC failure

As we are still within the tax year the 2017/18 underpayment can be corrected via this year's payroll filings by updating the year to date figures. You can do this in your next regular payroll "Full Payment

Submission”. Alternatively you can send an additional payroll submission before your next regular payroll submission is due.

The 2016/17 underpayment should also be corrected via the payroll. As the 16/17 tax year has ended, you should make an Earlier Year Update (EYU) to report the underpayment.

Penalties and interest may be due on the above amounts as described below.

Penalty for inaccurate returns

This is calculated as the taxes underpaid multiplied by a percentage which HMRC will set based on the behaviours giving rise to the underpayment and during the process of fixing the matter.

We will make a case to HMRC that you took “reasonable care” in relation to this matter which will produce the lowest possible penalty. However HMRC’s published view is that it is reasonable to expect a person who encounters a transaction or other event with which they are not familiar to take care to find out about the correct tax treatment or to seek appropriate advice. As a result they may not accept our position unless we can provide some proof that Fresh Air Ltd took these steps.

We believe it is possible that HMRC would consider this was a careless error. Our estimated penalties are based on this.

We would not consider that this was deliberate behaviour. If this error takes place again, the likelihood is high that HMRC would consider it deliberate behaviour for any future penalty calculations for the same mistake.

The standard penalty for a careless error would be 30% of the underpaid income tax and Class 1 NIC. This comes to £12,699 for both years.

As we are voluntarily bringing the underpayment to HMRC’s attention (making an “unprompted disclosure” using their terminology) and if we are helpful to HMRC in quantifying and fixing the error we should be able to reduce the percentage. The minimum possible penalty is 0%.

We recommend disclosing the underpayment to HMRC as soon as possible and cooperating with them fully.

If HMRC do determine a penalty is due it is possible to ask HMRC to suspend the penalty for a set period. If we can demonstrate that we have put in place steps to prevent the same error from occurring during that set period they will cancel the penalty at the end of the period.

Penalty for late payment of PAYE/NIC

We should consider the 2016/17 and 2017/18 underpayments separately for this purpose. The late payment penalty percentage depends on the number of payments made late during the tax year and whether any payment is more than 6 months or more than 12 months late.

For 2016/17 there were three months in which the payments were made and the PAYE on each is more than 6 months but less than 12 months late. Therefore the late payment penalty is 6% of the underpayment which comes to £693.

For 2017/18 if we make an additional payroll submission correcting the error by the end of November 2017 there will have been 8 months in which payment of PAYE was late and for 2 of these months the payment will have been more than 6 months late. As a result there will be a penalty of 3% for 6 months’ worth of the late paid PAYE and 8% for 2 months’ worth. This comes to £1,308

Late payment interest

Daily interest will also accrue from the due date to the date of payment at HMRC late payment interest rate which is currently 2.75%.

Potential for income tax claims on Jennifer Green’s Self-Assessment tax returns

Assuming that Jennifer has kept sufficient evidence she will be able to claim employment expense deductions on her self-assessment tax return for some of the spending. This will reduce the income tax payable on the return and will trigger a refund of some of the income tax you will have paid over to HMRC.

Amounts spent on her travel expenses, accommodation and reasonable meals for herself while travelling will all be claimable as business expenses.

Amounts spent on business entertaining will not be claimable as the monies were provided to Jennifer as part of a cash payment designed to cover a range of expenses. HMRC refer to this as a Round Sum Allowance.

Jennifer may be willing to enter into an agreement to transfer the income tax refund generated by any such claims to the company. Please note that you cannot compel Jennifer to do this as there appears to be no legal agreement covering this situation. The repayment is legally due to Jennifer but HMRC will repay it to Fresh Air Ltd as her employer on mandate from Jennifer. This can be done when completing her Self-Assessment Tax Return.

We would recommend that you engage us to prepare these tax returns for Jennifer.

Proposed future arrangements for Jennifer Green

UK tax residency

From the information we have been given it appears likely that Jennifer Green will remain UK tax resident throughout the three years she is travelling to France as she is not working abroad full time and plans to spend more than 183 days a year in the UK. Our comments are based on this assumption. We recommend that Jennifer's situation is kept under regular review throughout her travels.

French tax residency

Per the comments from the Air Frais SARL Head of Finance it appears that Jennifer is likely to be considered non-resident for tax in France based on the current plans. We would recommend you also consult a French tax specialist for their advice.

Treaty residency

The interaction of the French and UK taxes on Jennifer's income will be governed by the terms of the France-UK Double Taxation Agreement. For the purposes of interpreting this treaty we would expect that Jennifer will be considered "treaty resident" in the UK.

This will automatically be the case if she is non-resident for tax in France and tax resident in the UK.

If she does become tax resident in France she would have dual tax residencies. In a dual residency case we first look to see in which country the individual has a home continuously available to them. In Jennifer's case she will have two homes. Her family home in the UK and the rented apartment in France.

We then look to see where the individual's "Centre of Vital Interests" lie. In Jennifer's case, she is employed by a UK company and her family are based in the UK so we would consider that her centre of vital interests is in the UK. As such she would still be considered "treaty resident" in the UK.

If Jennifer's circumstances change during the period she is spending time working in France this could change the analysis. It is important that her situation is monitored on a regular basis. We would suggest annual conversations with a tax adviser such as ourselves.

Liability to UK tax and French tax on employment income

Jennifer will continue to be liable to UK tax on her worldwide employment income.

It is possible that France will want to tax the income relating to Jennifer's duties under their domestic legislation. If so we would need to turn to the UK-France DTA to see whether the French tax authorities would have the right to tax her employment income.

They will if any one of the following circumstances apply;

i) Jennifer is present in France for more than 183 days in any rolling 12 month period. For this purpose any part of a day would count as a full day so any travel days will count.

ii) Her remuneration is considered to be paid on behalf of a French employer such as Air Frais SARL. Different countries have varying interpretations of this treaty condition and we recommend that you engage a French tax specialist for their advice.

iii) Her actions have created a taxable presence (also known as a "permanent establishment") of Fresh Air Ltd in France.

If French taxes are due Jennifer will be able to claim a credit for these taxes against her UK income tax liability. The amount of the credit will be the lower of the French taxes paid and the UK taxes due on the same income. If the French tax rate of 20% given by the Air Frais SARL CFO is correct the French taxes paid are likely to be offset by a refund from the UK authorities. As a result they should not produce an overall additional tax cost.

If Fresh Air Ltd loan Jennifer the monies to make her French tax payments this loan may count as a taxable benefit for Jennifer. This will be the case if the amount loaned exceeds £10,000 at any point in the year and the company either do not charge Jennifer any interest or charge interest at a lower rate than HMRC's official rate of interest. The taxable benefit will be the difference between the interest calculated at HMRC's official rate of interest and any interest which is actually paid.

I note that Jennifer is a director of Fresh Air Ltd. Per Companies Act 2006 any loans given to a director of a company which is not a wholly owned subsidiary of another company must be approved by the shareholders by ordinary resolution. We recommend you discuss the proposed method of managing Jennifer's taxes with your legal advisers and the board of directors. If they have concerns we would be happy to work with you to explore alternative approaches to making sure that Jennifer does not suffer a cash flow disadvantage due to any French taxes payable.

Social security

Under the European Social Security Agreement Jennifer is considered a Multi-State Worker. This means that she regularly performs employment duties in more than one European country.

It appears likely that she will remain resident in the UK for NIC purposes as well as income tax purposes as her family home will be in the UK. Additionally she will continue to perform a substantial portion of her duties in the UK.

She will remain liable to UK social security contributions on her worldwide employment income. No French social security contributions will be payable.

An application should be made to HMRC for a certificate called an A1 to prove this status. You can find the forms for making this application on HMRC's website. Alternatively we would be happy to make this application for you.

PAYE obligations of the UK firm

Fresh Air Ltd will be required to operate PAYE and NIC withholding on all of Jennifer Green's employment income throughout the period she will be partly working in France.

Jennifer Green's employment contract

If an employee has to work abroad for more than a month, their employer must provide a written statement providing details of the currency in which they will get paid, additional remuneration and any terms and conditions relating to return to the UK. We would suggest that you have the proposed

agreement with Jennifer reviewed by an employment lawyer to make sure it meets all the necessary conditions under UK and French employment laws.

UK Income tax and NIC implications of the various travel related items

It appears that Jennifer expects to spend more than 40% of her working time at the French offices for a period of longer than 24 months. As a result HMRC would consider this a permanent workplace.

Elements of the travel package you will be providing for Jennifer will be chargeable to UK income tax and NIC. I have commented on each item in turn and calculated the additional tax costs for Fresh Air Ltd. You will note that I have used “grossed up” rates for this calculation. This is because HMRC will consider any taxes that you pay on these items as additional taxable income for Jennifer. These grossed up rates take this into account when calculating the tax cost.

Flights

The provision of a weekly return flight will be tax exempt. There is a specific exemption in the tax legislation for travel costs reimbursed by an employer where an individual is performing duties partly outside of the UK. No reporting of this amount by either Fresh Air Ltd or Jennifer Green is required. We recommend that you keep records of the amounts paid and the assessment of these amounts as tax exempt.

Accommodation

The provision of the accommodation will be considered a taxable benefit. Fresh Air Ltd will bear the cost of the tax on this benefit. The implications differ between the two alternatives.

If Fresh Air Ltd entered into the rental agreement the taxable value of the apartment is the amount of rent paid by the company. This is reportable on Jennifer Green’s P11D and the tax payable on submission of her UK tax return.

Class 1A NIC would be payable by Fresh Air Ltd on the same taxable value. This is due by 22 July each year for the previous tax year if paying electronically. You’ll need to pay by 19 July if paying by post.

Income tax, as well as class 1 employer and employee NIC would be payable on the income tax being paid by Fresh Air Ltd. The payment should be reported via the payroll in the month the income tax is paid.

This option would cost Fresh Air Ltd roughly £11,000 per annum in income tax and NIC. (Appendix 2)

If Jennifer were to enter into the rental agreement and Fresh Air Ltd were to make her a cash payment each month the cash payment would be subject to income tax and Class 1 NIC.

The payment should be made through payroll and grossed up to account for the income tax and Class 1 NIC so that Jennifer is left with sufficient funds to pay the rents due. It will be important to monitor this payment on a regular basis. Changes in foreign exchange rates and potentially UK tax and NIC rates will mean that the gross payment may need to be adjusted.

This option would cost Fresh Air Ltd roughly £11,500 per annum in income tax and NIC. (Appendix 2)

We would recommend that that the company enter into the rental agreement with the French landlord rather than Jennifer. This produces a slightly lower overall tax cost to the company. Additionally it is less administratively burdensome as the income tax and NIC can be managed at one time at the end of the tax year via the P11D process and it would remove the need for a monthly analysis of the correct gross payment to be made to Jennifer.

Tax Returns

The fees charged by our firm and any French advisers for Jennifer’s tax returns should be reported as an additional benefit in her P11D and will be taxed at her marginal tax rate. Class 1A NIC would be payable by Fresh Air Ltd on the same taxable value.

Matters relating to the integration plans

Launch event – French staff

The French staff attending will be exempt from UK income tax.

Assuming they are non UK resident for tax purposes, the time spent in the UK at the launch event can be considered merely incidental to their work outside of the UK and so can be treated as duties performed outside of the UK.

There will be no UK income tax due for these individuals and no reporting requirements for Fresh Air Ltd.

If Fresh Air Ltd plans to bring the Air Frais Sarl staff to the UK to perform more substantive duties in the future we recommend that you put in place an Appendix 4 short term business visitor agreement with HMRC. This will ensure that a PAYE obligation is not triggered in respect of any of these staff who should be exempt from UK income tax under the terms of the France-UK DTA.

Launch event –UK staff

The sandwich lunches and the celebration dinner would be considered as staff entertaining by HMRC.

As the sandwich lunches will be provided in the Fresh Air Ltd offices, are likely to be "on a reasonable scale", and are available to all Fresh Air Ltd employees then the provision of these meals will be considered exempt from taxation.

As the celebration event is being held at a restaurant the same rules do not apply.

If this is to be the first in a series of annual events for the employees of Fresh Air Ltd and VAT inclusive costs are held to £150 per head or less there would be the possibility we could exempt it from taxation.

My comments below assume that this exemption is not available as there is no indication that this will become an annual event and based on the budget the event will have a VAT inclusive cost of approximately £185 per head (£10,000 *120% / 65 = £185).

I have also assumed based on the information provided that the celebration event is for staff members only and no clients (potential or current) will be in attendance. Please let me know as soon as possible if this is not the case as it would have an impact on the tax implications.

The provision of this event will be considered a taxable employment benefit for the Fresh Air Ltd employees. The value of the taxable benefit is cost to employer which will be the VAT inclusive cost of £12,000.

Fresh Air Ltd is able to recover the VAT on the provision of staff entertaining. I have assumed that spouses or other partners of the Fresh Air Ltd employees will not be invited to the celebration dinner. If they are this will change the ability to recover the VAT paid on the costs of the event as any VAT paid on the cost of the attendance of non-employees is not reclaimable. Additionally, if spouses were to be in attendance this would imply that the cost per head is likely to be less than £150 per head. If so, we should discuss further the potential for tax exemption for annual staff parties mentioned above.

There are two options for dealing with the taxable benefit.

It could be reported on the P11Ds of each attending UK staff member. There would be a class 1A NIC liability payable by the company at 13.8% of the benefit value. The tax would be paid by the employee either on submission of a tax return, or via PAYE through an adjustment in their PAYE coding. This option is cheaper for the company but may cause some employee dissatisfaction.

Alternatively, the company can enter into a PAYE Settlement Agreement (PSA) with HMRC whereby they agree to pay both the income tax and the NIC. HMRC will agree that a PSA can be used for items that are minor, irregular or impracticable to divide between employees. Staff entertaining is commonly included on a PSA.

A PSA must be agreed with HMRC by the 6 July following the end of the tax year that it relates to. If the launch event and celebration dinner takes place before the 5 April 2018 you therefore have until 6 July 2018 for the PSA to be agreed. We would recommend approaching HMRC much sooner than this.

I have done the estimated PSA calculation on the basis that all staff attending are higher rate taxpayers. To be able to provide a more precise calculation we will need to how many basic rate, higher rate and additional rate taxpayers will be attending the event.

On this basis I have estimated that the after tax cost to the company of the launch event is circa £23,000. This takes into account the additional income tax and NIC payable with the PSA and also the corporation tax deduction of all relevant amounts. (See Appendix 3)

Appendix 1: Calculation of under paid income tax and NIC on cash paid to Jennifer Green

Net monthly cash payment		£4,000
Gross up for income tax and Class 1 employee NIC (net payment *42/58)		£2,897
Deemed gross cash payment		£6,897
Income tax @ 40%		£2,759
Class1 Employee NIC @2%		£ 138
		£2,897
Class 1 Employer NIC @ 13.8%		£ 952
Total monthly underpayment		£3,849
PAYE underpayments for 16/17 (3 months)		£11,545
PAYE underpayments for 17/18 (8 months)		£30,786
Standard penalty for inaccurate returns @ 30%		£12,699
Penalty for late payment of PAYE for 16/17 @6%		£ 693
Penalty for late payment of PAYE for 17/18 (April and May) @8%		£ 616
Penalty for late payment of PAYE for 17/18 (June to November) @3%		£ 693

Appendix 2: Annual tax cost of the provision of Jennifer Green's French Apartment

Fresh Air Ltd to enter into the rental contract		
Annual Rental Cost (£1,000 per month)		£12,000
Class 1A on the taxable benefit @ 13.8%		**£1,656**
Higher Rate Tax on the taxable benefit @ 40% (Payable with Tax Return)		**£4,800**
Payroll gross up (£4,800 * 42/58)		£3,476
Gross payment for payroll purposes		£8,276
Income tax payable via payroll (40%*£8,276)		**£3,310**
Class 1 Employee NIC (2%*£8,276)		**£166**
Class 1 Employer NIC (13.8%*£8,276)		**£1142**
Total additional income tax and NIC cost		**£11,094**

Jennifer Green to enter into the rental contract		
Net monthly payment £1,000		£12,000
Payroll gross up (£12,000 * 42/58)		£8,690
Gross payment for payroll purposes		£20,690
Income tax payable via payroll (40%*£20,690)		**£8,276**
Class 1 Employee NIC (2%*£20,690)		**£414**
Class 1 Employer NIC (13.8%*£20,690)		**£2,855**
Total additional income tax and NIC cost		**£11,545**

Appendix 3: Cost to the company of launch event

PSA Calculation (Assumes all UK staff are higher rate tax payers)		
	Air Frais SARL staff (£)	**Fresh Air Ltd staff (£)**
Daily sandwich lunches (VAT inclusive cost £2,200 * 15:50)	EXEMPT	EXEMPT
Celebration dinner (VAT inclusive cost - £12,000 * 15:50)	2,769	9,231
Net Cost		9,231
Grossed up UK tax @ 40/60		6,154
Gross cost		15,385
Class 1B NIC @ 13.8% of gross cost		2,123
After tax cost of the launch event		
	£	
VAT Inclusive cost	22,200	
Income tax and Class 1B NIC payable through PSA	8,277	
Expected VAT recovery	-2,200	
Total gross cost	28,277	
Estimated corporation tax reduction @ 19% of gross cost	-5,373	
After tax cost	£22,904	

Requirement 2

MEMO

To: Charles Dunn

From: Ann Brown

Re: Fresh Air Ltd Report

Dear Charles,

Please find my preparation notes for the Fresh Air Ltd report below. These notes focus on matters where I believe that Fresh Air Ltd would benefit from advice from one of the other specialist teams in our firm.

I agree that Fresh Air Ltd need some French tax advice but I don't think it is appropriate to just refer them to the same firm we used last time. Per the Professional Rules and Practice Guidelines a CIOT member should take care when making referrals and aim to give the client a choice of adviser. We should also make it clear to Fresh Air Ltd that we have no responsibility for the work undertaken by the French Tax adviser.

We should also review our engagement letter and ensure that it gives us the ability to advise on matter relating to any company in the Fresh Air Ltd group. We should list Air Frais SARL as a member of the group and ensure that Fresh Air Ltd are aware that they must let us know of any changes to the group structure.

Finally, while there is no reason to believe that Fresh Air Ltd will not take our advice as to the disclosure of the underpaid tax on the round sum allowances paid to Jennifer Green their reaction needs to be monitored and action taken in accordance with Institute guidelines and money laundering legislation if necessary.

Kind regards

Ann

Permanent Establishment risk for Fresh Air Ltd

Jennifer Green has signed a contract in France on behalf of the UK company Fresh Air Ltd. Additionally it is proposed that she will spend a significant portion of the next three years engaging in fee generating activities in France as an employee of and acting on behalf of the UK company.

I would recommend that these circumstances are reviewed to consider whether there is a risk that the French tax authorities would consider that Jennifer was an agent habitually carrying on business activities in France on behalf of Fresh Air Ltd. If so Fresh Air Ltd could be considered to have created a permanent establishment in France. This would require them to file French corporate tax returns and pay French corporation taxes on any profits generated.

If Fresh Air Ltd is considered to have created a PE in France and as a result pays French tax on profits earned in France it will be able to claim double tax relief in its UK corporation tax return to avoid having tax charged twice on the same profits. The relief available would be the lower of the UK corporation tax due on that source of income and the French tax suffered.

However, even if the actual tax cost is low there will be substantial administrative costs and professional fees associated with having a PE in France which Fresh Air Ltd would most likely wish to avoid.

Potential transfer pricing issues with new French contract

The information provided indicates that the French client has signed a contract with the UK company Fresh Air Ltd but that a significant portion of the work will be carried out by the staff of the French company Air Frais SARL. As Air Frais Sarl is owned 100% by Fresh Air Ltd they are considered

connected parties for transfer pricing purposes. It appears likely that they may be exempt from the transfer pricing rules in the UK under the exemption for small and medium sized companies. However I think our corporate tax team should review this. French tax advice should also be taken on this point.

VAT on fees issued from Fresh Air Ltd to French client

Fresh Air Ltd is a UK business supplying services to another business. The place of supply of these services is considered to be where the recipient of the services is based. France in this case. As a result the supply is outside the scope of UK VAT. Fresh Air Ltd should not charge any VAT when issuing their invoices. As the client is within the EU they will have to account for the French VAT using the reverse charge system.

Fresh Air Ltd many need assistance with VAT aspects of their invoicing. Additionally, in the light of the permanent establishment concerns raised earlier in this note I believe it important that our VAT team consider carefully whether Fresh Air Ltd will create a fixed establishment in France for VAT purposes.

Other corporation tax implications of the purchase of Air Frais SARL

Fresh Air Ltd may benefit from some corporate tax advice on the implications of owning a non UK resident company.

As Air Frais SARL is now controlled by Fresh Air Ltd which is a UK resident company it would be considered a Controlled Foreign Corporation. Under the CFC rules, potentially some Air Frais SARL profits would need to be included in the Fresh Air Ltd corporation tax return.

While it seems likely that this arrangement would fall within one of the CFC exemptions I think our corporate tax team should review this.

Potential implications of loans to Jennifer Green if Fresh Air Ltd is a close company

Jennifer is a company director at Fresh Air Ltd. I recommend that we confirm whether she is also a shareholder in the company. If she is, it is important to assess whether Fresh Air Ltd should be considered a close company. If so, the company may have to account for provisional tax under s455 CTA 2010 on any loans made to Jennifer. This would be calculated at 32.5% of the lower of the loan outstanding at the last day of the company's chargeable accounting period or the normal due date for the company's corporation tax.

As it would appear that Jennifer should be considered a full time director of Fresh Air Ltd, if loans outstanding at any one time do not exceed £15,000 and Jennifer does not have a material interest (>5%) in the company then they will be excluded from the treatment described above.

Reclaiming VAT on employee expenses

It does not appear possible for Fresh Air Ltd to reclaim VAT on any purchases made by Jennifer Green while she was in receipt of the £4,000 per month round sum allowance. In the case of employee expenses HMRC relax the condition that the purchase must have been made directly by the VAT registered entity. However this is only applicable where such expenses are specifically reimbursed to the employee. They do not allow relief for round sum expense allowances even if Jennifer could account for exactly what she had spent.

Our VAT department may be able to advise on whether a claim is possible for expenses likely to be incurred in the future. Where VAT is incurred in France there is the possibility for Fresh Air Ltd to recover this VAT under the EU Electronic Cross-Border Refund Scheme.

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