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## **Professional negligence: Look both ways**

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*Julian Miller & Tom Pangbourne assess the dangers of tax avoidance schemes*

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### ***In Brief***

- Capital allowances introduced to promote investment in British industry have been restricted, leading to some claims for tax relief being disallowed.
- Professional advisers are being targeted by disappointed investors in capital allowance relief schemes.
- In the context of prevailing economic conditions, such claims against professionals are likely to continue.

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Claims against professional advisers in relation to their role in tax avoidance schemes are on the increase. This article examines the basis of such schemes, and why solicitors, barristers and other professionals involved in their implementation may be at risk.

### **Capital allowances tax reliefs**

A number of capital allowance tax reliefs were introduced by the Labour government after 1997 which were designed to encourage investment in particular areas of British industry. This included investment in British films (under s 48 of the Finance (No 2) Act 1998), in technology start-ups (under s 45 of the Capital Allowances Act 2001) and in research and development (under s 437 Capital Allowances Act 2001). Despite best intentions, inevitably this attracted not just those wishing to invest in the relevant sector but also high net worth individuals seeking to utilise the tax reliefs without any real interest in the underlying asset. This artificiality led to increased scrutiny by HMRC, the gradual restriction of the reliefs available, and the failure of several schemes.

## Investment schemes

While there are differences in detail, the basic mechanism of a typical scheme was usually as follows. Investors would seek to become members of an investment vehicle (usually some form of partnership structure) and would invest 20% of the acquisition costs of the qualifying asset. The balance of 80% would be provided by a bank loan to the partnership. The partnership would purchase the asset from the vendor, often under a sale and leaseback agreement. There were side agreements whereby the vendor would place much of the purchase price in a guarantee account as security against the partnership's bank loan. This left the vendor free to market the asset under the leaseback arrangements and provided the partnership with a qualifying investment. Tax relief was sought by partners against their proportion of the loss represented by the 100% acquisition costs. Carry across relief and carry back relief would be available against other sources of income for the current and previous tax years (Taxes Act 1988 ss 380 and 381). Carry forward relief was also available against profits of the partnership in future years, although in practise this was rarely used as there was a risk that the relief would be wasted if the venture was not profitable, as was often the case. Thus, using these reliefs, for an investment of (say) £20,000 a higher rate tax payer could generate a loss of £100,000, on which relief would be granted at 40%, providing a tax rebate of £40,000. This would leave the tax payer better off by £20,000 in the year of investment.

Under schemes which deferred (rather than eliminated) tax, in the year of investment, the partnership was to be treated as making a 100% loss to be set off against the partners' income. Under the leaseback arrangements, over time tax would be payable on income under the lease. This had a potential to erode the initial tax advantage (which is why the schemes were usually marketed as tax deferral schemes). In practise there was often an "exit strategy" whereby the partnership would divest itself of its entitlement to the income under the leaseback arrangements to ensure that the tax was avoided altogether. Alternatively, for certain individuals (for example high earners approaching retirement) deferring taxation would mean a lower rate of tax would eventually be paid since tax would be levied on lower income. Other schemes provided tax relief, which were designed to eliminate the tax payable altogether, often over a number of years.

## HMRC review of schemes

HMRC has been looking at these schemes with a critical eye for some years, because some of the schemes have been highly artificial, tax driven, with negligible prospects of commercial success. The mechanics of the reliefs were gradually altered from 2002 onward. The Finance Act 2002 restricted relief on British films only to those genuinely intended for cinematic release. Restrictions on the use to which trading loss could be put were introduced in 2004, and prevention of "double-dipping", whereby the same films were used to generate losses twice, eg for production, then for acquisition, was put in place in 2005. The reliefs themselves have sometimes been restricted, often effective immediately on ministerial statements being made. In addition, HMRC has disallowed some of the reliefs sought on a case-by-case basis. Commonly its decision was influenced by the use of circular finance, the lack of a trade on a commercial basis with a view to the realisation of profit, or failure properly to acquire the asset.

There have been a number of high profile cases as a result. These include the Tower MCashback litigation (*Tower MCashback LLP 1 and another v The Commissioners for Her Majesty's Revenue & Customs* [2010] EWCA Civ 32, [2010] STC 809, [2010] All ER (D) 66 (Feb)), a key issue in which was circular funding. HMRC

argued that expenditure had not been incurred since the borrowing was on uncommercial terms, as a result of which there was no real expenditure. HMRC succeeded at first instance but the taxpayers prevailed on appeal. The court found that, because the partnership had acquired the full rights to the software and was therefore able to use it to generate income, expenditure had been incurred and the tax reliefs should be allowed. This decision may be reviewed in a further appeal to the Supreme Court.

The investors are not always successful and, indeed, many settle with HMRC for a lower than anticipated relief. In those circumstances, the professional advisers may be targets if the investors have sustained losses or contend they might otherwise have invested in schemes on which full relief would have been given.

## **Involvement of professional advisers**

Those advising the investor on the decision to invest, such as their accountant or IFA, may be exposed to claims if they were retained to advise but failed to do so, or if an investor can prove a representation was made that schemes were "guaranteed" to work.

Barristers, solicitors and accountants assisting the scheme promoters may also face claims from investors. Particular issues may arise if a law firm's client account has been used to hold investors' monies. Both barristers and solicitors may have had a role in advising on tax and regulatory issues. The framework documents, and various ancillary agreements, are likely to have been drafted with their input. Together with accountants they may also have advised on appeals from decisions made by HMRC. Where there is no client relationship with investors it may be more difficult for investors to bring a claim.

The quantum of these claims will depend on the approach taken by HMRC. If settlement between HMRC and the investor is reached by an agreement under s 54 TMA 1970, then the investor should be expected to give credit for the value of the tax relief received in any claim for the return of their capital investment. In some cases HMRC has agreed to give relief on the expenditure actually incurred by the claimants. So, using the example above, an investor might be permitted relief on their £20,000 contribution at 40%, ie £8,000. The claim put forward by the claimant investor should therefore be £12,000, although some claimants are attempting to advance claims for the full £20,000.

Since the reliefs in question have been restricted or withdrawn, what of the future?

Despite the tightening of the legislation, many such schemes continue to operate and provide tax efficient investment. For example, in the context of film schemes, investment vehicles might agree to produce a film for film producers. This agreement is reached on the basis that the actual work is carried out for the vehicle by a subsidiary of the film producer. The investment vehicle can record the fees paid to the subsidiary as work in progress, and as a loss in the profit and loss account. That loss can then be attributed to investors' own tax returns for which loss relief can be sought in the usual way.

Most claims have settled out of court, so the full extent of the duties of an investor's professional advisers, or those advising the scheme promoter, have not been tested in this context.

Given the current economic climate, it is likely that HMRC will continue to review the workings of past and present investment schemes. A statement published by HM government alongside the recent budget confirmed it intends to examine whether the adoption of a general anti-avoidance rule should form one element of a strengthened tax system. Where reliefs are withdrawn, it is inevitable that those involved will look to their advisers, and other professionals involved in the schemes.

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