# TC02769

**Appeals numbers: TC/2011/1825 & 3461**

***INCOME TAX – scholarship income – s 776 ITTOIA 2005 – benefits-in-kind – s 212 ITEPA 2003 – predecessor legislation in ss 165 & 331 ICTA 1988 – whether scholarships paid to sons of director – yes - whether scholarships taxable on father – yes - appeal dismissed***

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**MR SLAVOMIR KUTCHA** **Appellants**
**R A COWEN & PARTNERS LIMITED**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS** **Respondents**

**TRIBUNAL: JUDGE PETER KEMPSTER**
**MRS BEVERLEY TANNER**

**Sitting in public at Priory Courts, Birmingham on 14 February 2013**

**Mr Martyn Arthur (Martyn F Arthur Forensic Accountant Limited) for the Appellants**

**Mrs Ros Shields (HMRC Appeals Unit) for the Respondents**

## DECISION

1. The first Appellant ("Mr Kutcha") is a director of the second Appellant ("the Company"). The Company made payments to Mr Kutcha's sons, David Kutcha and Stefan Kutcha, over several years while they attended university, which were subject to PAYE and NIC in the normal manner. HMRC have assessed the payments to David and Stefan for those years as being taxable on Mr Kutcha as a benefit-in-kind. There is a consequent NIC liability assessed on the Company.

## Legislation

2. The disputed assessments cover the tax years 2002-03 to 2005-06, which span changes in the relevant legislation.

3. Section 776 Income Tax (Trading and Other Income) Act 2005 ("ITTOIA") came into force for tax years 2005-06 onwards, replacing s 331 Income and Corporation Taxes Act 1988 ("TA"). The wording of both is given below.

> **"331 Scholarship income**
>
> (1) Income arising from a scholarship held by a person receiving full-time instruction at a university, college, school or other educational establishment shall be exempt from income tax, and no account shall be taken of any such income in computing the amount of income for income tax purposes.
>
> (2) In this section "scholarship" includes an exhibition, bursary or any other similar educational endowment."

> "**776 Scholarship income**
>
> (1) No liability to income tax arises in respect of income from a scholarship held by an individual in full-time education at a university, college, school or other educational establishment.
>
> (2) This exemption is subject to section 215 of ITEPA 2003 (under which only the scholarship holder is entitled to the exemption if the scholarship is provided by reason of another person's employment).
>
> (3) In this section "scholarship" includes a bursary, exhibition or other similar educational endowment."

4. Sections 212 and 215 Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") came into force for tax years 2003-04 onwards, replacing s 165 TA. The wording of both (so far as relevant) is given below.

"**165 Scholarships**

(1) Nothing in section 331 shall be construed as conferring on any person other than the person holding the scholarship in question any exemption from the charge to tax under section 154.

(2) For the purposes of this Chapter, any scholarship provided for a member of a person's family or household shall, without prejudice to any other provision of this Chapter, be taken to have been provided by reason of that person's employment if it is provided under arrangements entered into by, or by any person connected with, his employer (whether or not those arrangements require the employer or connected person to contribute directly or indirectly to the cost of providing the scholarship).

(3) Section 154 does not apply to a benefit consisting in a payment in respect of a scholarship—

(a) provided from a trust fund or under a scheme; and

(b) held by a person receiving full-time instruction at a university, college, school or other educational establishment; and

(c) which would not be regarded, for the purposes of this Chapter, as provided by reason of a person's employment were subsection (2) above and section 168(3) to be disregarded;

if, in the year in which the payment is made, not more than 25 per cent of the total amount of the payments made from that fund, or under that scheme, in respect of scholarships held as mentioned in paragraph (b) above is attributable to relevant scholarships.

(4) & (5) [not relevant]

(6) In this section—

(a) "scholarship" includes an exhibition, bursary or other similar educational endowment;

(b) [not relevant]

and section 839 applies for the purposes of this section."

5.

"**212 Scholarships provided under arrangements entered into by employer or connected person**

(1) A scholarship which is provided for a member of an employee's family or household is to be regarded for the purposes of this Chapter as provided by reason of the employment if it is provided under arrangements entered into by—

(a) the employer, or

(b) a person connected with the employer.

(2) Subsection (1) applies whether or not the arrangements require the employer or the connected person to contribute directly or indirectly to the cost of providing the scholarship.

(3) A scholarship is not to be regarded as provided by reason of an employment by virtue of subsection (1) if—

(a) the employer is an individual, and

(b) the arrangements are made in the normal course of the employer's domestic, family or personal relationships.

(4) This section is without prejudice to section 201(3)."

"**215 Limitation of exemption for scholarship income** …

If an employment-related benefit consists in the provision of a scholarship, [s 331 TA or s 776(1) of ITTOIA] (exemption for scholarship income) applies only in relation to the holder of the scholarship."

6. Also relevant is HMRC Statement of Practice 4/86. The text of SP4/86 below is as given in the Yellow Tax Handbook 2004-05 because that helpfully includes details of certain financial limits that were amended over time.

"**SP 4/86 (8 August 1986) Scholarship and apprenticeship schemes at universities and technical colleges**

TA 1988 s 331 exempts from income tax, a scholarship, exhibition etc held by a person receiving full-time instruction at a university, college or school or other educational establishment. This statement of practice indicates the circumstances in which payments made by employers to employees for periods of attendance on a full-time educational course, including "sandwich" courses, are treated in practice as exempt from income tax.

1 Where an employee is released by his employer to take a full-time educational course, including a "sandwich" course, at a university, technical college or similar external educational establishment, payments made to the employee for periods of attendance at the educational establishment (but not for periods spent at work whether during vacations or otherwise) are treated as exempt from income tax where the following conditions are satisfied—

(a) the period for which the employee is enrolled at the educational establishment is at least one academic year and the actual full-time attendance at that establishment during that period amounts on average to at least twenty weeks a year;

(b) the rate of payment, including lodging, subsistence and travelling allowances but excluding any university, etc, fees payable by the employee, does not exceed the higher of £7,000 a year (£5,500 prior to 6 April 1992) (£5,000 prior to 5 April 1989 and £5,500 between 6 April 1989 and 5 April 1992) (or the equivalent monthly or weekly rates) and the rate of payment which an individual in similar personal circumstances would have received as a grant from a public awarding body on a scale fixed by the Secretary of State for Education and Science (eg a studentship from one of the Research Councils).

2 Payments are taxable in full where the rate exceeds that in (b) above. An increase in the rate of payment beyond the qualifying limit, part of the way through a course, will not affect any entitlement to exemption for the earlier part of the course, and a period of full-time instruction at a rate of payment not qualifying for exemption will be counted as a period of attendance at an educational establishment for the purposes of (a) above.

3 An employer's own internal training school or centre, or one run by an employers' association, etc is not regarded as an educational establishment for the purposes of this Practice. Only recognised universities, technical colleges etc, open to the public at large and offering a range of courses, both practical and academic, qualify."

**Appellants' Case**

7. Initially Mr Arthur sought to persuade us that there were no scholarships paid to David and Stefan; he said that description had been latched onto by HMRC following a meeting with the Company in September 2008 and HMRC had just assumed that scholarships had been paid by the Company; salaries paid to the two sons had been properly reported on their self-assessment returns and by the Company on Forms P60, and PAYE and NIC correctly accounted for by the Company thereon; there was no evidence that scholarships had been paid to either son.

8. A document produced by the Appellants was a schedule showing for each of David and Stefan gross earnings for all tax years 1999-2000 to 2011-12. Mr Arthur stated he understood the schedule had been prepared by the Company's accountants. The Tribunal put it to Mr Arthur that:

(1) For each individual certain tax years were annotated "S". Certain of those annotations indicated periods that coincided with academic terms – eg "S started Sept 02" and "S to July 2007". We considered it a reasonable inference that "S" stood for "scholarship".

(2) The amount paid, for example, to each individual in 2003-04 was £6,999.96. That appeared to be an amount engineered to stay just below the ceiling for scholarships set by SP 4/86 for that tax year (£7,000). We considered it a reasonable inference that the payments were intended to be scholarships that qualified for exemption.

(3) The income reported on the P60s in the relevant tax years showed no (or minimal) income tax deducted by way of PAYE. We considered it a reasonable inference that no PAYE had been deducted because the payments were intended to be scholarships that qualified for exemption.

(4) Mr Arthur's own skeleton argument referred to "The decision to award scholarships …".

9. During a brief break in the hearing Mr Arthur telephoned his clients to take instructions, and on resumption he confirmed to the Tribunal that the Appellants now accepted that the payments to David and Stefan were constructed to enable the taxpayers to benefit from the statutory exemptions available for scholarship income.

We are concerned by this *volte face*; one interpretation would be that the Appellants or their advisers were attempting to mislead the Tribunal by alleging that HMRC had fabricated (or at least misconceived) the existence of the scholarships. However, we are prepared to give the Appellants and Mr Arthur the benefit of the doubt and assume that there was merely a breakdown in communication between them.

10. Mr Arthur referred to written statements made by two executives of the Company (Mr Williams and Mr Chaplin) – neither of whom were in attendance at the hearing and thus not available to answer questions – stating that the reason for the payments to David and Stefan was to ensure the successful future of the business and lock those individuals into the Company. Mr Arthur submitted that Mr Kutcha had not been instrumental in that decision, although we do not see that expressly stated in the statements of the two executives. Mr Arthur submitted this demonstrated that the payments to David and Stefan were by reason of the sons' employment by the Company, not by reason of Mr Kutcha's employment. Both sons were still working in the Company.

11. Mr Arthur submitted that HMRC were wrong to assess benefits-in-kind on Mr Kutcha under the relevant legislation because the payments were not made by virtue of Mr Kutcha's employment.

(1) Section 212 ITEPA was explicitly subject to s 201(3) ITEPA (see s 212(4)), which provided:

> "A benefit provided by an employer is to be regarded as provided by reason of the employment unless—
>
> (a) the employer is an individual, and
>
> (b) the provision is made in the normal course of the employer's domestic, family or personal relationships."

As the employer (the Company) was not an individual, one had to consider whether the payments were made in the normal course of the employer's family etc relationships, or instead as normal commercial arrangements. The evidence from the two executives showed that there was a commercial arrangement here.

(2) Section 212 ITEPA replaced s 165 TA from April 2004. Section 165 was explicit that the relevant employment was that of (in the current case) the father whereas s 212 had in mind that the employments of (in the current case) the sons was relevant. Also, s 215 felt it necessary to draw a distinction between the holder of a scholarship and the employee.

**Respondents' Case**

12. For HMRC Mrs Shields submitted as follows.

13. None of Mr Kutcha, David, Stefan or the Company's accountants or executives had seen fit to attend the hearing and answer questions that HMRC wished to put to them. Despite requests, copies of the employment contracts for David and Stefan had not been produced until a formal disclosure direction had been made by the Tribunal.

HMRC's view was that Mr Kutcha had taken an opportunity to fund his sons' education through the Company in what was expected to be a tax efficient manner.

14. Neither David nor Stefan was a *bona fide* employee during the periods of time that they were at university. Their respective employments ceased when they left to go to university and then restarted when they rejoined after graduation.

15. The payments to David and Stefan were taxable on Mr Kutcha by virtue of the benefit-in-kind provisions. The only relevant employment for the purposes of the provisions was that of Mr Kutcha by the Company.

**Consideration and Conclusions**

16. We do not accept HMRC's contention that the employment contracts of Stefan and David are not valid contracts. Both individuals worked in the Company for several years after graduation and Stefan also worked in the Company for three years before going to university. Those employments continued throughout the time both individuals were in receipt of the scholarship payments from the Company. In general, SP 4/86 would be otiose if employments were deemed to cease or be suspended during the period of full-time education.

17. The treatment of the payments to both Stefan and David in the Company's payroll and PAYE system was consistent with the Company's understanding and intention that those payments constituted scholarships that would benefit from the tax exemption conferred by s 331 TA and s 776 ITTOIA, under the terms of SP 4/86. Payments during the university courses were made without deduction of tax, and tax was deducted once the course finished (and in Stefan's case, before he started his course). It even appears that the amounts of the payments were carefully tuned to stay within the financial limits imposed by SP 4/86.

18. Although s 776 ITTOIA grants an exemption to the person receiving the scholarship, s 212 ITEPA imposes a benefit-in-kind charge where the person receiving the scholarship (say, A) from a company is a member of the family of an employee (say, B) of the company: "*A scholarship which is provided for a member of an employee's family or household is to be regarded for the purposes of this Chapter as provided by reason of the employment if it is provided under arrangements entered into by (*a*) the employer, or (*b*) a person connected with the employer*." That benefit-in-kind charge arises to the employee (B), not the person receiving the scholarship (A). We do not accept Mr Arthur's submission that in circumstances where the person receiving the scholarship is also an employee of the company, then s 212 can be read so as to shift the benefit-in-kind charge away from the employee (B) and onto the person receiving the scholarship (A). Also, we consider the same effect is given for the tax year 2002-03 by the predecessor legislation in s 165 TA. The result is that a benefit-in-kind charge arises to Mr Kutcha (the employee) in relation to the scholarship payments made by the Company (his employer) to both Stefan and David Kutcha.

19. We also do not accept the point that Mr Arthur advanced in relation to s 201(3) ITEPA. We read that provision as applying only where the employer is an individual. There are then additional requirements but those are additional not alternative to the requirement for the employer to be individual.

20. Neither advocate advanced any arguments concerning the Class 1A NIC assessments raised on the Company but our understanding of the relevant legislation is that our decision on the income tax aspects of the appeals also settles the NIC aspects.

**Decision**

21. We DISMISS the appeal by Mr Kutcha against the income tax assessments in dispute. We give this as a decision in principle as we did not hear argument concerning the detailed figures – if the parties cannot agree on exact figures then they have leave to approach the Tribunal to determine those figures.

22. We DISMISS the appeal by the Company against the NIC assessments in dispute. Again, if the parties cannot agree on exact figures then they have leave to approach the Tribunal to determine those figures.

23. This document contains full findings of fact and reasons for the decision and replaces the summary decision notice issued to the parties on 19 February 2013. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

**PETER KEMPSTER**
**TRIBUNAL JUDGE**

**RELEASE DATE: 28 June 2013**