



TAX PLANNING BULLETIN

Issue No. 14

Summer 2005

Introduction

It is high Summer but before we know it the lead in to the November pre-budget report will be upon us. The Granville Strategy is still available to relieve the Capital Gains of individuals and trustees from taxation. Will it be nullified at the time of the Pre-Budget Report or even before?

If your clients have realised, or will realise, gross Capital Gains of £500,000 or more you should contact us as soon as possible.

With Government expenditure rising inexorably the Government is casting around to find any shift which will raise extra revenue. One such shift is the increased noise of its propaganda stigmatising tax planning as morally equivalent to tax evasion. This is nonsense. Tax planning is based upon respect for the law. It is always open to HMRC to demonstrate that a piece of planning fails to achieve the effect at which it aims and it remains open for the taxpayer to avoid creating liabilities to taxation by astute planning of his transactions. The inspiring words of Lord Clyde in *Ayrshire Pullman Motor Services & Ritchie v CIR* remain both good law and correct morality:-

“ No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.

The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue.”

Sharon Anstey

Simon McKie

CAPITAL GAINS TAX

1. Goodwill and Incorporation

Background

With the transfer by a sole trader of his business to a newly incorporated company in which he has a controlling interest, it often happens that the company buys the goodwill of the business. HMRC have found themselves challenging the value attributed to transferred goodwill and the tax consequences in circumstances where it is established that the payment exceeds the market value of the goodwill. While similar considerations apply to the transfer of goodwill from a partnership to a company, an article in the April 2005 Tax Bulletin focuses on transfers by sole traders.

When might the value of goodwill be challenged?

HMRC are concerned about cases where a transfer of goodwill may have taken place at an overvalue. In such case the excess value will be wholly or partly sheltered from tax (because of various CGT reliefs), whilst simultaneously inflating a loan account balance against which a proprietor could withdraw sums without any tax liability. They say they may have concerns where the goodwill acquired by the company falls within the intangibles regime (FA 2002 Sch 29). Also, cases may arise where the type of goodwill reportedly sold to the company was associated with the personal skills and attributes of the sole trader such as to make it incapable of being transferred to a company.

Under HMRC's free Post-Transaction Value Check service, CGT valuations can be referred to Tax Offices for checking after the transaction but before submission of the relevant return. Each request for a valuation check should be made on Form CG34, available from HMRC's website.

Capital gains

The transfer of goodwill to a company in which the transferor and/or persons connected with him have a controlling interest is treated as having taken place other than at arm's length. Therefore the disposal by the individual and the acquisition by the company are deemed to have taken place at market value (TCGA 1992 ss.17, 18 and 286).

Excess value may be employment income

Where there has been a deliberate overvaluation of goodwill when sold to the company as an inducement for the individual to take up employment with the company, or in return for future services to be provided by the individual to the company, the excess payment will be taxable as earnings within ITEPA 2003 s.62. Where, exceptionally, excess value is paid in respect of the transferor's employment, but it cannot be described as 'earnings', the overvalue may be chargeable as a benefit under ITEPA 2003 s.203. Section 201(3) deems any benefit provided by the employer to be 'by reason of the employment'.

In such cases the reporting obligation on the employer will depend on whether the excess value is regarded as earnings or a benefit. Earnings should be subjected to PAYE. A benefit should be reported on Form P11D.

There is guidance in the Employment Income Manual (EIM) 21102 and 21120 on the general rule for calculating the value of a benefit for income tax purposes and the concept of 'making good'.

The excess value is also liable for Class 1 NICs because it derives from the employment and is therefore a payment of 'earnings' as defined in SSCBA 1992 s.3(1)(a). This treatment applies irrespective of how the payment has been characterised for income tax purposes (and there is no provision for 'making good' for NICs). The charges would be considered to have arisen on the day the goodwill transaction took place.

Where the excess value is treated as employment income, it may give rise to a Case I deduction for the cost borne by the company.

Excess value may be a distribution for tax purposes

In many cases the goodwill will have been transferred from a sole trader to the company before the company has commenced trading. There may be no evidence that any excess value constitutes earnings (or is a benefit). So, in the majority of cases in which goodwill is transferred from sole trader to company, HMRC expect that the transferor will have received any overvalue in his capacity as shareholder, rather than as an employee/director (Company Taxation Manual CT 1529). In such cases the excess value will, for tax purposes, be treated as a distribution by virtue of TA 1988 s.209(2)(b) or s.209(4).

For NICs, where the transferor receives any overvalue in his capacity as shareholder rather than as an employee/director, that is derived from a shareholding and not employment. The overvalue cannot therefore be classed as earnings under SSCBA 1992 s.3(1)(a) and does not attract NICs.

Where the excess value is a distribution, any income tax liability will arise only in the case where he is a higher rate taxpayer and the tax credit does not cover all of the Sch F liability. As for the company, the transfer of goodwill before 1st April 2004 will not affect the company's tax position in terms of characterisation of excess value as a distribution. For transfers on or after that date the distribution will have to be taken into account in computing corporation tax liability at the non-corporate distribution rate.

'Inadvertent' distributions may be unwound

Because of the uncertainties in establishing the value of goodwill there will clearly be occasions where a transfer is inadvertently caught by TA 1988 s.209(4). If it is clear that there was no intention to transfer the goodwill at excess value, and reasonable efforts were made to carry out the transaction at market value by using a professional valuation, then the distribution may be 'unwound'. But this will not apply if there is attempted (or actual) avoidance or if the overvaluation was intentional or if no professional valuation was obtained (Company Taxation Manual CT1529a).

Where it is agreed that an inadvertent distribution may be unwound, the individual must repay the excess value to the company. Where the original sale proceeds were credited to a loan account, that credit should be reduced, with effect from the date of the original transaction. If the individual has drawn from the loan account on the strength of the original credit, rewriting

the loan account to reflect the unwinding of the distribution may result in the loan account becoming overdrawn. If so, the company may be liable to tax under TA 1988 s.419.

The intangibles regime effective from 1st April 2002 allows companies to claim an income deduction for tax purposes based on the goodwill amortisation shown in their accounts. Where the goodwill was acquired from a related party (such as a sole trader who controls the company) the intangibles regime will apply only if the goodwill was created wholly after 31st March 2002 (Corporate Intangibles Research and Development Manual CIR11680).

Where goodwill has been acquired from a sole trader and income deductions are made under the intangibles regime, HMRC will be concerned to confirm both that the goodwill was created wholly after 31st March 2002 and that for tax purposes the value of goodwill equates to its market value (FA 2002 Sch 29 para 92 and CIR145010).

(HMRC Tax Bulletin Issue 76 April 2005)

Comment

The temptation to 'overvalue' goodwill on incorporation is obvious. Valuation of goodwill is of course an art rather than a science. But that temptation must be resisted, with clear contemporaneous evidence of market value from, perhaps ideally, a third party adviser. Not many will have found themselves making 'inadvertent' distributions as described by HMRC – though, if so, the offer may be worth accepting.

The implications of HMRC's analysis for compliance purposes are obvious.

The statement that HMRC will allow the "inadvertent distribution to be unwound" is a very strange concession indeed. Assuming the original transaction was intra-vires it can only be "unwound" by a new transaction. If a debt owing to the company is cancelled this must be by way of a gratuitous transaction. That would normally be treated, for tax purposes, as a capital contribution.

2. Identification of Shares on Emigration of Trust

Background

The rules in TCGA 1992 s.106A require, for CGT purposes, the identification of shares acquired within 30 days after the disposal of the shares in the same company and of the same class with the shares sold. This rule was introduced to prevent the previously common practice of bed and breakfasting to make use of a taxpayer's annual exemption. The question in this case was whether that rule could be employed to the advantage of the taxpayer, in this case an emigrating trust, to avoid the exit charge on the accrued gain.

Davies v Hicks: the facts

Mr Hicks had made two settlements. Under a CGT avoidance scheme the trustees sold shares, became resident in Mauritius and then purchased shares of the same class within 30 days. HMRC argued that s.106A operated to treat the originally acquired shares as still owned on emigration and therefore capable of being the subject of the deemed disposal at that point. It was common ground that, at the time of the emigration, the double taxation agreement

between the UK and Mauritius (which has since been altered) prevented a charge on the subsequent disposal of the shares, even though the settlor was interested in the trust and would normally have been taxable on the gain.

Mr Hicks argued that there was no deemed disposal of assets because at emigration the only assets were cash. He argued further that s.106A provided computational rules only and was not a deeming provision. This argument was supported by the Special Commissioners' decision. HMRC appealed, arguing in essence the following: the effect of s.106A(5)(a) was to deem the trust fund to consist of a holding of shares in the company which, when the settlement became non-UK resident, was deemed by s.80 to have been disposed of at market value: at that time therefore a chargeable gain accrued to the UK trustees which resulted in a liability to CGT for Mr Hicks.

The decision (ChD: Park J)

Section 106A was a computational section only, the operation of which was triggered by the disposal of securities. Once that computation had been performed, the application of s106A to that disposal was completed.

The purpose of the section was to lay down rules as to how the chargeable gain or allowable loss on that disposal was to be computed. The section had no further statutory function to perform in consequence of the disposal of those shares which had caused it to apply in the first place. The section did not operate in addition to cause the continuing settled property of the settlement to be treated for the purposes of different CGT provisions as consisting of assets different from those which actually were the continuing settled property.

In the present case s.106A operated in respect of the sale of 100,000 shares by the UK trustees, matching 99,100 shares with shares acquired in the following 30 day period and matching 900 shares on a 'last in first out' basis with shares acquired from Mr Hicks some time earlier. The section did not have the effect of changing the identity of other assets held by the trustees after they had sold the 100,000 shares, causing those assets to be regarded as shares in the company when they were not. The appeal was dismissed.

(Davies v Hicks 12.5.05 [2005] EWHC 847 (Ch) reported at [2005] STI Issue 20)

Comment

While this decision is largely of historic interest (as the Mauritius and any other relevant treaties have since been changed), it does illustrate a rather nice point on the strict wording of s106A. No doubt, had Parliament appreciated the point when changing the identification rules in 1998, the rule would have been broadened to embrace the HMRC viewpoint. But that merely represents 'ex post facto' comment. This case is not a matter of adopting a purposive approach to legislation – which on this issue was quite clear.

3. Company Residence: 'Central Management and Control'

Background

Chargeable gains accruing to a company which is not UK resident but, if UK resident, would be a close company are under TCGA 1992 s.13 apportioned to participators in the company who

are resident or ordinarily resident in the UK and who, if an individual, is domiciled in the UK. Apportionment of the gain follows their interests in the company subject to a 10% *de minimis* provision. Subject to anti-avoidance provisions, a no gain - no loss rule operates under s171 for transactions within UK resident 75% groups.

Wood and another v Holden: the facts

Mr and Mrs Wood were settlors of a number of non-resident settlements set up as a part of what the Special Commissioners described as a 'sophisticated scheme to avoid CGT'. The trustee of those settlements was the sole shareholder of a BVI registered company, CIL. In July 1996 CIL sold some shares to Eulalia, a Netherlands incorporated company and wholly-owned subsidiary of CIL. The scheme assumed that CIL and Eulalia were not merely incorporated outside the UK but were also resident outside the UK.

However, HMRC took the view that, while CIL was resident outside the UK, Eulalia was resident in the UK and made assessments on that basis. The gains made by CIL on the disposal of the shares were attributed to the trustee under TCGA 1992 s.13. Mr and Mrs Wood were assessed to CGT in respect of those gains, which were treated as accruing to them under s.86 (attribution of gains to settlors with interests in non-resident settlements).

The Special Commissioners had regard to two sets of principles regulating the question of where a company was resident for UK tax law purposes: (a) those established by case law referred to the common law of corporate residence and (b) those found in FA 1994 s.249, read with art 4(3) of the UK/Netherlands Double Taxation Convention. They found that under both sets of principles Eulalia was UK resident at the critical date and dismissed the appeal. Specifically, if the conduct of the sale of the shares by CIL to Eulalia indicated genuine involvement by the Dutch trust company as director in the decision-making process, that would support the contention that the company's central control and management was outside the UK.

However, having considered all the evidence, they decided that no real consideration was given by the Dutch trust company to CIL's offer to sell its shares to Eulalia: the Dutch trust company had simply fallen in with the wishes that Mr Wood expressed by his advisers. The only acts of management and control of Eulalia were the making of the board resolutions and the signing or the execution of documents in accordance with those resolutions.

The Special Commissioners did not consider that the mere physical act of signing resolutions or documents or the mental process preceding the physical acts sufficed for actual management. An effective decision as to whether or not the resolution should be passed and the document signed is required for actual management and that decision must, at least to some extent, be an informed decision.

The Special Commissioners' decision was appealed by Mr and Mrs Wood, arguing that s.171 applied to the disposal of the shares by CIL to Eulalia, on the grounds that both CIL and Eulalia were non-UK resident companies. It was common ground that if s.171 did not apply, the gain on the disposal of the shares by CIL was assessable on Mr and Mrs Wood.

The decision: ChD (Park J)

On a proper application of the law to the facts, the only tenable conclusion for the Commissioners to reach was that, under the common law of corporate residence Eulalia was resident in the Netherlands.

The test of a company's residence was the central control and management test. The Commissioners had erred in law because they applied the wrong test, or if they applied the right test, they came to a conclusion which could not properly be reached on an application of it. However, if that conclusion was wrong, the effect of s.249 read with art 4(3) was that by statute Eulalia was resident in the Netherlands, since its place of effective management was in Amsterdam. The appeal was allowed.

(Wood and another v Holden 8.4.05)

Central management and control must be shown to be in a particular jurisdiction

In one sense, as a full review of the law relating to corporate residence, the High Court judgment does not break any new ground. However, one interesting point arises, suggesting that the issue of residence is not merely whether it is inside or outside (in this case) the UK.

In paragraph 80 of the judgment, Park J says that HMRC needed to produce some evidence that the place of effective management was situated in a specific place in the UK:

'In my judgment it cannot be enough for HMRC simply to say that they are not sure what the precise place of residence of the company was but, wherever it was, it was situated somewhere in the United Kingdom.'

This particular passage does indeed give some support to the idea that central management and control must be positively shown to be in a particular jurisdiction (and indeed in a particular place in that jurisdiction). Maybe HMRC will not be too unhappy about this decision after all.

Application

This case is of particular interest to those involved in advising on structures for UK resident non-UK domiciliaries in relation to a family home in the UK. The structure would typically have an excluded property settlement owning shares in a non-UK company. Following the HL decision in *Dimsey* in 2000, the asset owned by the company is now likely to be an offshore specialty debt rather than bricks and mortar. But the matter of the residence of the company is of course of paramount concern. Professional advisers will be able to sleep more easily following the High Court decision (though it is understood that the case is proceeding to the Court of Appeal).

The above said, the quotation from Park J's judgment might seem to have put paid to future use of 'peripatetic companies', with successive board meetings being held in different jurisdictions. That is not necessarily true however. Companies which are not resident in the United Kingdom are generally outside the charge to Corporation Tax (TA 1988 s11) so residence (or deemed residence) in the United Kingdom is required to make a company fully chargeable to Corporation Tax. It is not sufficient that the company is not resident in another country.

INHERITANCE TAX

4. Transfer by Proprietary Estoppel?

Background

The doctrine of proprietary estoppel applies where a property owner has made a promise to transfer a property or an interest in it to another party but fails to make the requisite formal transfer. If the other party has, in reliance on that promise, prejudiced his position, the Court will make such orders as are necessary to do justice to the parties.

An important feature of the doctrine is that the Court has an extremely wide discretion as to the order to be made and is not in any way bound to see that the original, unenforceable, promise is carried out. Indeed, in most of the cases considered by the Courts, significantly less than what was originally promised has been ordered to be transferred. Clearly there may be an argument that, if the promisor dies, the property in his estate may be burdened by a possible proprietary estoppel claim – and this should be reflected in the valuation upon which IHT is based.

Moggs v IRC: the facts

In May 1996 the deceased wrote to his niece G inviting her to stay with him for a year as a guest at his property. The property was registered in the names of the deceased and his late wife as joint tenants. G went to stay with the deceased and their living arrangement was formally renewed annually over a meal.

In 1996 the deceased drafted a Will which was never executed, stating that provided G was still permanently resident in the property at his death she could reside there for life. In August 2000 after consulting a solicitor with G, the deceased transferred to G by way of gift a half-interest in the property as joint tenant. The transfer contained a statement that 'The transferor is solely and beneficially entitled in the property'. On the same day he signed a new Will leaving (in case she did not take by survivorship) his share in the property to her. The IHT on the gift and the legacy was payable out of the estate, which was left to the appellant, the deceased's son and co-executor. In April 2001 the deceased died. In March 2004 the Revenue issued a Notice of Determination stating that in relation to the transfer of the half-share in the property in August 2000 to G, having regard to IHTA 1984 s.3(1) the value of the deceased's estate immediately before the transfer included the entirety of the property with vacant possession.

The appellant appealed against the notice, contending that the gift of the property was made earlier than August 2000. He argued that the deceased's actions in favour of G, particularly in making the draft Will and providing for her, showed that he was making a gift to her of an interest in the property, on the basis of proprietary estoppel, on account of her 'commitment of care' to him.

The decision (SpC: Dr John Avery Jones)

There was insufficient evidence to show that a gift of a share in the house had been made by the deceased before August 2000.

Dr Avery Jones found on the facts that there was no earlier gift to G. If the deceased, who was a meticulous person (as shown in his letters to G), had made a promise to her that, in return for looking after him, she would have an interest in the property, he would have said so clearly and recorded it in writing. Furthermore, when the deceased did decide to make G a joint tenant of the property, he discussed it with her, consulted a solicitor and tied the gift in with a new Will which provided for the incidence of IHT on the gift. There were moreover a number of indications that the deceased had not intended to make an earlier gift of the property to her: the draft Will demonstrated that at that time he had not promised her any interest in the property in his lifetime. In addition, the statement in the transfer was an indication that it was not giving effect to a previous gift. The fact of the transfer of the property into joint names was a slight indication that it was unlikely that any arrangement had previously been made that would found a claim to proprietary estoppel; normally in such cases there was no subsequent actual transfer. The notice of determination was therefore confirmed and the appeal dismissed.

(Moggs (as Executor of Moggs deceased) v IRC SpC 464 3.3.05 [2005] SWTI Issue 14)

Comment

The doctrine of proprietary estoppel does not crop up very often, but, where it might be successful, is useful to bear in mind. The particular point here is that if a transfer is in fact made it is going to be very difficult to persuade the Court to make an order to treat the transfer as having taken place on a previous occasion. The more general point, noted above, is that the Court will make such order as it considers to be equitable and will not necessarily simply award the claimant what he or she is asking for.

5. The Home Loan Scheme: Deciding What to Do

Background

Suppose you take the view that your particular home loan scheme is caught by Sch 15. The effect of an election under para 21 is that FA 1986, s.102(3) and (4) 'shall apply' (see para 21(2)(b)(ii)).

Only the net value is brought back into the chargeable estate under an election

The recent Special Commissioner's decision in *Green v Mitson* is helpful in affirming that, under general principles, the value which is charged for IHT purposes is after the deduction of debts (that case held that excess liabilities in the free estate could not be offset against value in the settled estate). Therefore, the value that seems to be brought back into the chargeable estate by electing under para 21 is the value of the house at, typically, the date of death, but subject to the IOU, ie, the net value which would have been taxed in the free estate on death anyway. While that is a bizarre result, it seems to follow (though is of course vulnerable to a future change in the law).

A possible method of unscrambling

Alternatively, how might the arrangement be unscrambled without electing? The asset in the Debt Trust might be appointed to one or more of the beneficiaries (e.g. the settlor's daughter) if living in 14 days time. That is an absolute contingent appointment with no tax consequences at that point. Before the daughter becomes entitled, she assigns her entitlement to the settlor and the trustees of the property trust would then advance the property to the settlor.

Obviously any issues in terms of the duties and responsibilities of the trustees of both settlements must be resolved. A possible downside is if the settlor dies within seven years of creating the home loan scheme owning the value of the debt: there is a potential double charge in that the PET has become chargeable and is also taxed in his estate. Is this avoided by the Regulations SI 2005/724? HMRC need to confirm this before such an unscrambling is effected.

(CLT Conference 'Capital Tax Planning for the Family Home' 17th May 2005, lecture by Chris Whitehouse, to be included in a Meeting Points article for Taxation June 2005)

Comment

The analysis of the arrangement following an election under para 21 seems inescapable, albeit perhaps unforeseen by the legislators. The reason of course is that once an election is made, the income tax regime (with in particular, its 'excluded liabilities' rules) fails to apply – and so one is back to general principles. The only caveat, one supposes, is that if taxpayers caught by POA are clearly electing wholesale with an IHT consequence which HMRC find unacceptable, again, the law could be changed with 'retroactive' effect.

6. Pre-owned Assets Regime: Avoid by Sale to Spouse?

Background

Consider adapting the traditional double trust scheme by having a sale of the house to a spouse rather than to a life interest trust for the settlor.

Ensuring exclusion from POA by transfer to spouse

The settlor sells the property to his spouse for market value, the purchase price being satisfied by the issue of a debt on commercial terms which is not repayable until after the death of the survivor of settlor and spouse. The spouse gives away the debt to a trust from which both he and his spouse are excluded. The sale to the spouse will be an excluded transaction. Although the transaction may not be such as might be expected to be made at arm's length between unconnected persons (para 10(1)(a)(ii)), the disposal is a transfer to a spouse and is therefore excluded within para 10(1)(b). No right of occupation is retained by the transferor, who relies on the permission of the transferee.

It is essential that, as with the traditional home loan scheme, there is no bounty: if there were, FA 1986 s.102A would apply to bring in the GWR regime.

The success of the scheme depends on getting a deduction for the debt in the estate of the transferee spouse. Therefore the transferee must not have made gifts to the transferor which

would cause a disallowance or abatement to arise on the transferee's death under FA 1986 s.103.

(CLT Conference 'Capital Tax Planning for the Family Home' 17th May 2005, lecture by Sarah Dunn)

Comment

Part of the difficulty in considering and recommending to clients structures for the family home, either in response to past arrangements which may now be caught by the POA regime or in planning for the future, is that there is no guarantee that HMRC will not initiate legislation with 'retroactive' effect. This is a point that applies to, for example, the suggestion that a new reverter to settlor trust might cure any past POA problems – as indeed to this intriguing suggestion. Subject to the s.103 point, and of course assuming that the home loan scheme works in principle, the idea seems technically impeccable, by simply taking advantage of the unlimited spouse exemption in the POA regime.

STAMP DUTY LAND TAX

7. SDLT: Appointment of New Trustee(s) where Trust Fund is Subject to Mortgage

Background

Concern has been expressed that the strict wording of the SDLT regime (with, in particular, no *prima facie* distinction between legal and beneficial ownership) would make an incoming trustee of a settlement holding mortgaged land a 'purchaser' paying chargeable consideration equal to his *pro rata* share of the mortgage.

Question and Answer posted on the Law Society's Website

Question

Under the Stamp Duty (Exempt Instruments) Regulations 1987, a transfer of trust property to successor trustees on the appointment or retirement of a trustee was exempt from stamp duty (subject to incorporation of the relevant certificate in the document), regardless of whether there was some outstanding borrowing charged on the trust property such that the new and/or continuing trustees would take over responsibility for that borrowing from the retiring/former trustees.

This category of transfer is not reproduced in the Schedule 3 list of land transactions exempt from charge.

We cannot believe that there is a change of policy such as to tax the change of formal title on a change of trustees of a continuing trust where there is outstanding trust borrowing (seemingly, whether or not secured on the land being transferred). Can the Revenue please confirm the analysis below, publicly?

The assumption of existing debt by the "purchaser" - which would seem to be the new and/or continuing trustees as they would be parties – is only chargeable consideration if it is "consideration given for the subject-matter of the transaction, directly or indirectly, by the purchaser or a person connected with him" in the first place - see paras 8(1) and 1(1) of Schedule 4. We do not believe any trust lawyer would regard incoming or continuing trustees as giving "consideration" of any kind for the transfer to them of the trust property formerly held in the names of their predecessors, or for that matter for the appointment or retirement as such either. On that basis, it would seem that the transfer is exempt under para 1 of Schedule 3 (no chargeable consideration) and can be self-certified. Is this agreed?

Answer from Crispin Taylor

I agree with your analysis.

Application/Comment

Good news! Specifically, it seems that the Stamp Office consider that trustees are treated by FA 2003 Sch 16 as a continuing body of persons, so that there is no land transaction on a change of trustees [contrary to what Sch 16 appears to provide, however].

8. SDLT: the Disclosure Regime

Background

It was announced in the 2005 Budget that, as from 1st July 2005, arrangements designed to avoid SDLT on non-residential transactions with a consideration of at least £5 million would have to be disclosed, with the usual penalty of £5,000 for failure to do so within five days after the due date. Such disclosure would be something of an exception to the existing regime, in not requiring HMRC to issue a reference number or indeed the client to use the reference number in reporting the transaction. The whole idea was simply to increase awareness within the Stamp Office of what taxpayers might currently be getting up to!

Commencement date deferred

It has been announced that the new requirement will not take effect until 1st August 2005.

Application

One of the complaints about the application of the disclosure rules to SDLT is that the three filters (of confidentiality, premium fee and off-market terms) would not apply. And it appears that SDLT would be avoided in any case where the transactions were not done in the most SDLT inefficient way! It is hoped that one or both of these aspects might be relaxed over the next month.

MISCELLANEOUS

9. Settlements Anti-avoidance Legislation: HMRC Win in High Court

Background

Geoff and Diana Jones each owned one share in a company which earned profits by providing Geoff's personal services in his skilled field to clients. He drew a comparatively small salary from the company, so that it could earn more significant profits. The profits were distributed as dividends and Diana received half of them. HMRC's case was that the structure was an 'arrangement' within the settlement provisions, that Geoff Jones was the settlor of it and that the dividends paid to Diana were treated for income tax as her husband's income. Further, HMRC said that the case was not taken out of the settlement provisions by the exclusion of an outright gift by one spouse to the other.

Geoff's appeal was heard by two Special Commissioners. The presiding Commissioner (Nuala Brice) agreed with HMRC on both issues, first that the settlement provisions applied and second that the exclusion of outright gifts by one spouse to the other did not apply and was therefore in favour of dismissing the appeal. The other Commissioner (Judith Powell) agreed with Geoff Jones on both points, and was in favour of allowing the appeal. The presiding Commissioner exercised the casting vote for the appeal to be dismissed. Geoff Jones appealed.

HMRC contended that the corporate structure whereby—(a) Geoff Jones was responsible for earning all the income of the company; (b) he drew only very small remuneration; and (c) substantial dividends were expected to be paid, half of which went to Diana as her 50% interest in the company, was an 'arrangement' within s.660G(1), and therefore ranked as a 'settlement' for the purposes of s.660A. HMRC also contended that the structure was not taken out of the concept of 'settlement' in s.660A(1) by s.660A(6) since it was not an 'outright gift' by Geoff to his wife.

The decision: ChD (Park J)

Applying well-established principles to the facts of the case, the dividends paid to Diana Jones under her share in the company were income arising under an 'arrangement' of the sort identified by the authorities. Furthermore, s.660A(6) did not take the case outside the scope of s.660A(1).

Diana Jones paid £1 for her share and she worked in the business, but did so part-time, and she was paid adequate remuneration for the work she did. On her £1 share she received substantial annual dividends. All of the receipts of the company which enabled it to make profits and to pay dividends, were attributable to Geoff Jones and he drew only modest salaries. In the circumstances, if there was an arrangement and thus a settlement, there could be no doubt that Geoff Jones was the settlor of it.

Given the Court of Appeal judgement in *Crossland v Hawkins (1961) 39 TC 493*, on which Park J placed much reliance, the answer must be that there is an 'arrangement' within the statutory definition of 'settlement'. The actor Jack Hawkins entered into a common surtax avoidance scheme in the mid-1950s. Two subscriber shares in a new company were issued to clerks in his accountant's office and Mr Hawkins agreed to a service contract for the next three

years with the company for which he would be paid £50 per week plus expenses. The aim will have been to accumulate as much income as the old apportionment rules would allow, with a view later to liquidating the company and avoiding surtax on the capital amount – just as one might do now for taper relief! But some months later a settlement for the benefit of Mr Hawkins' children was created by their grandfather for £100 and £98 of this was used to subscribe for 98 shares in the company. When the company paid a dividend in 1956, almost all of it went to Mr Hawkins' children and the question was whether this was a settlement of which Mr Hawkins was the settlor.

The key finding by the Court of Appeal was that a combination of transactions, including one (the creation of the settlement) which was apparently not in contemplation when the company was formed, could form an arrangement which fell within the anti-avoidance provisions, and in particular within the definition of a settlement which was almost identical to the current definition in s660G. Mr Hawkins was a settlor of the settlement by indirectly providing funds for it: his work generated income which was indirectly diverted into the settlement.

In concluding that there was an arrangement, and thus a settlement of which Geoff Jones was the settlor, the Court disagreed with the view of Judith Powell that there was no arrangement because there was no element of bounty at the time when the company was established and Diana Jones acquired her one share in it. The Court accepted that there was a difference between a present intention to provide bounty and the actual provision of it later, but did not accept that, if a structure was created with the intention that it should be a means of providing bounty year-by-year in future, it was not an arrangement within the meaning of s.660G(1). The word 'arrangement' carried the notion that the arrangement comprehended not just the specific things which happened when the arrangement was made, but also the reason or reasons why the arrangement was being made. If a structure was being established in circumstances where one of the reasons for it was that it would be used as a means through which bounty would, or might be, channelled to another person in future, that was fully within what the cases contemplated as an arrangement covered by the statutory definition.

Finally, that which constituted the 'settlement' in the instant case was not an outright gift at all.

(Jones v Garnett 27.4.05 reported at [2005] SWTI Issue 18)

Comment

It seems that a consortium for costs has been established and that there will be an appeal to the CA. However, given that the High Court judgement relies heavily on the 1956 Court of Appeal decision in *Hawkins* (and that the CA would be bound by its own authority), it seems curious that the case does not go direct to the HL.

Meanwhile, FA (no.2) A 2005 will introduce anti-avoidance legislation to apply from 2 December 2004, targeted at so called 'alphabet schemes'. Here, typically an owner managed-business might award different classes of shares to different employees (and I have come across a case where 50 classes were awarded to 50 employees!) enabling below-market salaries with benefits to be topped up by way of NI free dividends. Now there will be an NI liability where 'something has been done which affects the employment-related securities as part of a scheme or arrangement the main purpose (or one of the main purposes) of which is the avoidance of tax or national insurance contributions'.

Interestingly therefore, the concept of a market salary (the fact that Geoff Jones was paid less than that having persuaded Park J to decide for HMRC in *Jones v Garnett*) appears here too. So, even if (improbably, in our view) *Jones v Garnett* were ultimately to be decided in favour of the taxpayer, the NI saving aspects of the dividends would not be effective for the future, insofar as the main wage earner is paid less than a 'market salary'!

10. Trust Management Expenses

Background

The Revenue issued in September 2004 what was called an 'explanatory note' on the subject, of which some fairly trenchant criticism was made by the CIOT, among other bodies. Having been promised a response to this in the 2005 Budget, a revised version of the paper was issued on 16th June.

At first glance much of the revised paper is identical to the original, although we have been told that a further note on trustee remuneration (which generally HMRC say is not allowable for income tax purposes!) is promised. In cases where the CIOT appealed to decided cases to challenge the HMRC interpretation, the text just seems to reappear - restating the principle merely, without reference to the cases.

Certainly, the specific examples given in the final section 9 show that HMRC's interpretation generally remains more rather than less restrictive. What follows summarises a few points made in the revised paper (on which further representations are being made). Presumably HMRC are expecting that tax returns for 2004/05 and subsequent years will reflect the new guidance.

General points

The basic, and correct, distinction is made between distributions of income and payment of expenses. Distributions are not expenses and so can never be allowable TMEs.

Incurred as they are in the capacity of trustee, TMEs are not like other expenses for tax purposes. Notions of 'capital' and 'income' are those that apply to trust law and not to tax law.

TMEs in trust law

Section 2.5 of the revised paper says '*The approach of Judges in decided cases is that if an expense is incurred solely for the benefit of, or in the course of the husbanding of, the income fund held by trustees then it should be paid out of income. Otherwise it should be paid out of capital.*' Husbanding 'the income fund' means managing the trust assets in a manner calculated to procure, maintain or improve a satisfactory income pool and/or flow. Very few categories of expenses can be said to be incurred *solely* for this purpose.

Comment: the above test, which prevails through the whole of the paper, is too narrow.

Accumulation/discretionary trusts

Section 3.6 states that trustees' remuneration is not allowable because it is not an '*expense of the trustees*': TA 1988 s.686(2AA) limits allowable expenses to such expenses.

Section 4.7 states that income ‘*applied in defraying the expenses*’ of the trustees as referred to in statute, means that the amounts must actually be paid and it is not enough that they are incurred. In other words accruals of expenses are not allowed for tax, according to HMRC.

Interest in possession trusts

Taken out of the beneficiary’s income entitlement and therefore his tax liability are:-

- charges properly met by the trustees out of income, eg annuities;
- income which the deed directs needs to be applied for specific purposes, eg the redemption of a lease or mortgage; and
- trust management expenses properly chargeable to income.

As the beneficiary is taxable on income as it arises, it follows that TMEs should be allowed on an ‘incurred’ basis rather than when paid (5.12).

Subject to taking out of account for tax purposes items mentioned above, the beneficiary is entitled to the untaxed amount of the income net of income expenses including TMEs. Therefore, it is a net amount which is grossed up at the appropriate tax rates to arrive at the amount included in the beneficiaries’ income for income tax purposes. As stated at 6.3, the income tax paid by the trustees on that part of the income used to defray the TMEs and other items excluded from the beneficiary’s entitlement is not part of his entitlement, because the income out of which the tax is paid is not part of that entitlement. But the rest of the tax paid by the trustees represents income to which he is entitled.

Example at 6.3

An IIP trust receives income in 2003-2004: rental income £1,000 and bank interest £800 (lower rate tax of £200 has been deducted at source). Trustee pays TMEs properly chargeable to income of £250.

Trustee's position

	<i>Rent</i>	<i>Interest</i>
<i>Gross income</i>	<i>1,000</i>	<i>1,000</i>
<i>Tax due</i>	<u><i>220</i></u>	<u><i>200</i></u>
<i>Net income</i>	<i>780</i>	<i>800</i>

The trustee receives credit for the tax deducted at source from the bank interest (£200) so has to pay £220 tax. TMEs do not affect the trustee's position.

Beneficiary’s position

	<i>Rent</i>	<i>Interest</i>
<i>Net income (as above)</i>	<i>780</i>	<i>800</i>

Minus TMEs (set primarily against lower rate income) $\frac{--}{780}$ $\frac{(250)}{550}$

grossed up (@ 22%) 1,000 (@ 20%) 687.50

In the example above the entries on the form R185 (Trust Income) given by the trustees to the beneficiary would be:

	Net amount	Tax credit	Tax amount
7.4	780	7.5 220	7.6 1,000
7.7	550	7.8 137.50	7.9 687.50

The beneficiary uses the information on form R185 (Trust Income) to make his or her tax return or to claim repayment. The beneficiary is taxable on the gross amounts at boxes 7.6 and 7.9 at his or her marginal rate, and is given credit for the amounts at 7.5 and 7.8.

Settlor-interested trusts

No trust management expenses are allowed over and above the normal deductions for each source of income. So the settlor is taxed on the gross taxed income. Under TA 1988 s660A the settlor is also taxable on the trust management expenses (8.1 and 8.2).

Specific items

The cost of having trust accounts prepared is allowable insofar as relating to accounting for the trust income. Similarly, the cost of having trust accounts audited and the cost of preparing trust tax returns.

Tax advice is allowable only if related directly to the preparation of income tax returns.

The allowability of bank charges and interest depends on what those charges secure and the actual use of the funds advanced (which must be questionable). In many cases therefore HMRC would say that they are not allowable.

Other non-allowable items according to HMRC include:-

- depreciation;
- costs of distributing income;
- insurance premiums for trust assets (subject to specific exceptions);
- interest (except where on a loan to purchase an income-producing asset or some bank interest – see above);
- interest on unpaid or overdue tax unless where inheritance tax or under TMA 1970 s86;
- personal expenses of beneficiaries;
- property costs (except where the property is properly held for the occupation of a beneficiary);
- administration costs; and
- travel and subsistence costs, generally.

(Trust Management Expenses Discussion Paper June 2005: Trust Management Expenses – Explanatory Note)

Comment

It is understandable that HMRC should be unhappy at what they see to have been extravagant claims to expenses particularly in accumulation and discretionary trusts. However, the hardline approach adopted in this revised explanatory note seems quite 'over the top', both in applying established case authority and in over-riding previous HMRC practice. Further strong criticism can be expected.

NOTE: You should not act (or omit to act) on the basis of this Bulletin without specific prior advice.

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