



TAX PLANNING BULLETIN

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Introduction

Mr Micawber and the Artful Dodger

Gordon Brown gave his Pre-Budget Report on Monday reprising his much loved impressions of Mr Micawber and the Artful Dodger. On the one hand he is planning to spend staggering amounts of money requiring the Government's income to increase to levels which would strain the credulity of even the sunniest optimist in spite of having had to admit the failure of his previous estimates. On the other, he announced that he will confiscate even more of the national wealth in ways that will affect the prosperity of ordinary voters without them realising it.

So we have proposals to increase the charge on oil companies at a time of high energy prices and a new charge on planning gains when the development of new homes is in danger of stagnating. As always, myriad anti-avoidance provisions are to be introduced, the complications and uncertainties of which will choke and impede commercial activities.

Amongst all this, the Chancellor has nullified our own beloved Granville Strategy for the future but not for those clients who had the foresight to implement it before the Pre-Budget Report. When its success is finally determined, we shall be proud if we have played our part in protecting some portion of our clients' wealth from excessive taxation. The tax saved will "fructify in the pockets of the people", as Gladstone said, to the benefit of our clients and of the British economy as a whole.

Much has been made of the Governments' attack on tax planning. The environment has undoubtedly harshened as the Government has desperately searched for ways to raise extra money without raising headline rates of taxes. But as the weight of the Government's profligacy becomes ever more burdensome so the need for high quality tax planning advice increases.

As old strategies are cut down new strategies will be developed. In the coming weeks we shall analyse the new provisions in detail and we shall share that analysis with you in our next



bulletin. Meanwhile in this issue we make our normal selection of some of the more interesting new developments in the world of private client taxation.

We would like to wish all of our clients and contacts a very happy Christmas and good fortune in the New Year. We hope that we shall all resume work in the New Year refreshed and ready to continue the good fight.

Sharon Anstey

Simon M^cKie

CAPITAL GAINS TAX

1. Garden or Grounds: Sales 'Off'

Context

There is a traditional problem with getting relief under TCGA 1992 s.223 where only part of the grounds are sold and the area concerned exceeds the 'permitted area' of 0.5 of a hectare. This is the HMRC argument that, if a taxpayer is now selling part of the garden or grounds, that area larger than 0.5 of a hectare cannot be required for the 'reasonable enjoyment of the dwelling-house' – as demanded by s.222(3).

HMRC's Capital Gains Manual offers two general exceptions to this difficulty

First, it is made clear at paras CG64832 – 64834 that the inference may be displaced where the owner of the land made the disposal to a member of his family and was prepared to tolerate some effect on his ability to use and enjoy his own residence. Second, HMRC accept that the inference may not be correct where it is financial necessity which has forced the owner to sell land which would otherwise appear to be part of the most suitable area of garden or grounds to be included within the permitted area (as provided by s.222(4)).

COMMENT: It is well established that the test to be applied in establishing the permitted area larger than 0.5 of a hectare is objective, not subjective, so that the Manual's statement is quite clearly wrong. On the other hand, if it is possible in appropriate circumstances to take advantage of either of these 'concessions', then why not?

2. The Second Home: Getting it Down a Generation

Context

As is well known, FA 2004 Sch 22 put paid, as from 10th December 2003, to the traditional device of the combination of hold-over relief under s.260 and main residence relief for the trustees under s.225 on disposal of the residence following occupation by a beneficiary under the terms of the settlement. Interestingly, however, although hold-over (whether under s.165 or s.260) is no longer possible into a settlor-interested trust, the combination of s.165 hold-over and s.225 relief remains possible with a non settlor-interested trust.

Furnished holiday accommodation (FHA) is a business asset for s.165 purposes

It would be pretty unlikely (although possible) that a second property owned by one or both of a couple had throughout the period of ownership been used as FHA, so as to qualify for complete hold-over under s.165. Of course, if the property had been used as such for only part of the period, the amount of the gain which can be held over is cut down under Part 2 of Sch 7.

The definition of FHA (formerly in TA 1988 ss.503 and 504) has been replaced for non-corporate taxpayers by new ITTOIA 2005 s.325. The accommodation will satisfy 'the availability condition' by being available for commercial letting as holiday accommodation for the public generally for at least 140 days; the letting condition is that it must be commercially

let as holiday accommodation to members of the public for at least 70 days (for which purpose a period of longer-term occupation is not such a letting); and the 'pattern of occupation condition' is that during the relevant period not more than 155 days fall during periods of longer-term occupation. A 'period of longer-term occupation' is a continuous period of more than 31 days during which the accommodation is in the same occupation other than because of circumstances that are not normal. The 'relevant period' is defined by s.324 as, broadly, the tax year, subject to a special rule which operates when the accommodation first becomes let as furnished accommodation.

The planning suggestion

In the more normal case, a person (let us say individually) owns a second property used by the family generally as a holiday home. There is an in-built gain. Suppose that he is married and the husband transfers the property to wife by way of gift. For CGT purposes this happens on a no gain - no loss basis under TCGA 1992 s.58. In particular, the wife's acquisition date is the date of gift and not, under s.222(7)(a) the date of the husband's acquisition. She then lets the property as FHA for a decent period – i.e. for at least a year. It is then open to her to give the property to a trust (whether or not discretionary – so the value is immaterial) from which both she and her husband are excluded from benefit. The gain is held over under s.165. The trustees allow one of the children to occupy under the terms of the settlement and on a subsequent disposal the whole of the gain, including that arising before the date of settlement, is effectively 'washed' under s.225.

INHERITANCE TAX

3. Pre-Owned Assets Regime: Regulations – Further Relief Announced

Context

The Regulations published on 16th 2005 provide double charges relief in circumstances where a person has effected a double trust scheme and has elected into GWR under FA 2004 Sch 15 para 21, dying within seven years after the scheme was transacted (see our Bulletin Issue No 13 Spring 2005, Item 3). Representations were made that the terms of the relief were unduly restrictive and Dawn Primarolo has agreed to extend them.

Double charges relief where the scheme has been unscrambled

The Paymaster General has pronounced herself satisfied that scheme users can have legitimate non-avoidance reasons for unscrambling the scheme within the terms of the trusts rather than electing into GWR. The regulations already made will therefore be extended to provide relief from double charges which arise, in cases where:

- a deceased person has made a gift of a debt owed to them;
- the gift was chargeable to IHT or has become so chargeable (by virtue of the donor's death);
- the donor dies within seven years of the gift and on or after 6th April 2005;
- the debt was entered into as consideration for the purchase of an asset owned by the donor, or to provide funds for such a person; and
- the full value of that asset, or of property derived from it, is also chargeable to IHT as part of the donor's estate at death.

In those circumstances relief will be given so that IHT will be due only on the more valuable of the two chargeable assets mentioned. Regulations will be made as soon as practicable and made available on HMRC's website.

(Treasury Written Ministerial Statement 21.7.05)

COMMENT: Representation on various POA points continues to be made to HMRC. Whether examining the application of FA 2004 Sch 15 to an arrangement done in the past or considering the fiscal implications of any unscrambling within the terms of the arrangement or by electing into GWR into para 21, the results are not always what one might expect them to be – and so very careful analysis is required.

4. Pre-owned Assets Regime: Compliance

'Other taxable income'?

It appears that the 2005/06 self assessment forms will contain neither a dedicated box nor a supplementary page for taxpayers to return any income tax liability arising under FA 2004 Sch 15. Instead, such taxpayers will simply have to tick the box at current Question 13 for 'other taxable income' and put the appropriate figure into what is now box 13.3. (Presumably the same will apply to those completing the short tax return, where the box will be current 7.1 with no box to tick to confirm a liability.)

COMMENT: Representations have been made, by the CIOT among other professional bodies, that this is inadequate and that greater publicity is required for the new regime (on which public awareness is understood to be low). Ideally, there would be a separate supplementary page or at least a separate box in both the long form and the short tax returns.

5. IHT and Pension Simplification

Context

The Paymaster General's written statement of 21st March 2005:-

- made it clear that existing IHT legislation would continue to apply to choices made by pension scheme members;
- noted that the existing SP published in 1992 would no longer be valid once the changes to pension rules in FA 2004 come into effect from 6th April 2006; and
- said that HMRC would publish a consultation document to inform discussion towards a revised practice.

HMRC discussion paper

That paper has now been published and the paper:-

- sets out existing IHT law to all relevant pension choices;
- outlines briefly how it has been applied up to now;
- describes how pension choices will change post-A Day;
- discusses the implications of current IHT law for these situations; and
- invites representations on how, in the light of this, IHT law should be applied in practice, or, if respondents regard that as impracticable in any respect, how it should be modified.

HMRC reiterate the overriding concern that, in particular in relation to individuals aged over 75 who convert the balance of their pension scheme into an alternatively secured pension (ASP), this should not enable the passing of value down a generation following death free of IHT. The particular issue is the circumstances in which the charge under IHTA 1984 s.3(3) – omission to exercise a right – might apply where a person who is entitled to draw a pension dies before age 75 or, where he has reached age 75, some parts of the pension pot are left in the ASP and have not then been annuitised. HMRC call for changes to the IHT rules which are focused on the practical issue of designing a charge which is workable in post A-day situations and is not aimed at fundamentally reducing the IHT exposure of wealth built up in pension schemes with a view to onward transmission.

HMRC request representations on:

- the sort of considerations which are likely to be relevant in assessing chargeability under s.3(3), particularly having regard to the position where a member dies;
 - (a) before reaching age 75; and
 - (b) after reaching age 75, having not secured their pension benefit;
- the weight that might reasonably be given in the different circumstances; and
- (if any sensible estimate can be given) the proportion of scheme members dying at age 55 plus where IHT under s.3(3) might be (a) seriously in question; and (b) due.

(HMRC Consultative Document 22.7.05)

COMMENT: In recent years HMRC have adopted the practice of asking whether there had been any events within two years before the death, such as paying further premiums into a policy written in trust, taking out a new policy and writing it in trust or writing an existing policy in trust, at a time when the policyholder knew himself to be in poor health. Evidence of health is, according to HMRC, to be provided by letter from the individual's GP. However, there are always problems in considering *ex post facto* evidence of intention.

It remains to be seen what sort of response HMRC will get to their request. They remain concerned about the possible use of pension arrangements to engage in IHT mitigation. That said, and depending upon the regime which ultimately emerges, a view might well be taken that, in the overall context of family affairs, payment of IHT at 40% on pension monies passed down one or more generations in (possibly) a tax exempt regime might be the sensible thing to do.

6. Agricultural Property Relief: Agricultural Value

Nearly two years after the original decision of the Special Commissioner, Dr Nuala Brice, in October 2003 in favour of the taxpayer in the *Antrobus* case, the matter of agricultural value has been determined by the Lands Tribunal – though not in terms which will bring great comfort to taxpayers generally. The decision was released on Monday 10 October. Finding for HMRC, the agricultural value was held in this case to equate to a 30% discount on market value (to be reduced to 15% if the Tribunal were wrong on the matter of 'lifestyle buyers').

However, the main 'shock horror' (though not germane to the particular facts of the case) emerges from para 49 of the decision which reads as follows:-

'The question is: who is the farmer of the land for the purpose of the definition in section 115(2)? In our view it is the person who lives in the farmhouse in order to farm the land comprised in the farm and who farms the land on a day to day basis. It is likely, although it may not necessarily always be the case, that his principal occupation will consist of farming the land comprised in the farm. We do not think that a house occupied with a farm is a farmhouse simply because the person living there is in overall control of the agricultural business conducted on the land; and in particular we think that the lifestyle farmer, the person whose bid for the land is treated by the appellant as establishing the agricultural value of the land, is not the farmer for the purpose of the provision. There are a number of pointers to suggest that this is the correct view.'

COMMENT: The Tribunal's distinction between the day to day farmer (which Miss Antrobus clearly was) and the occupant of the farmhouse who is in overall control of the business will mean, if generally applied for the future, that many houses which in the past would have attracted 100% APR will do so no longer. However, a careful reading of the decision suggests that the Tribunal had decided upon the finding it wanted to make and had then looked for reasons to justify its decision. In particular, the Tribunal's treatment of the evidence presented to it of actual sales seems questionable. And it is far from clear that the logic underlying the decision would be followed by another, in particular a higher, court.

While the expression 'lifestyle farmer' is clearly unhelpful (in that there will be many individuals following a different occupation who are nonetheless committed to the well-being of their farm in particular and the countryside in general), it is not at all clear that the Tribunal's conclusion

that a house cannot be a farmhouse unless it is occupied by a person who farms the land on a day to day basis is consistent with decided case authority in general.

It remains to be seen how the taxpayers in this particular case will choose to proceed. In view of the tax at stake and the costs of pursuing litigation will they consider it worthwhile to appeal? If the decision stands, there must be a question as to whether the finding in para 49 (in particular) could be challenged as going beyond the remit of the Lands Tribunal insofar as it deals with matters outside the strict scope of valuation.

Certainly, the Tribunal's agreement with the general approach of the District Valuer in applying a 30% discount from market value for agricultural value should not simply be accepted in any particular case, where the issue will depend on appropriate evidence and the facts of that case.

There is a lot of life yet left in this whole issue!

STAMP DUTY LAND TAX

7. SDLT: Disclosure of Tax Avoidance Schemes

Context - the FA 2004 regime extended

New rules which came into effect on 1st August 2004 were introduced by FA 2004 requiring promoters and users of certain direct tax schemes to disclose details of those schemes to HMRC. Initially limited to employment products and financial products, Budget 2005 announced that the regime would be extended to SDLT transactions for non-residential property for a consideration of at least £5 million. (There is a separate regime for VAT.) Draft regulations were published for comment on 24th March 2005 with a proposed commencement date of 1st July 2005. Following discussion between HMRC and representative bodies and tax advisers, the commencement date for the SDLT rules was revised to 1st August 2005 and regulations introduced represent the response by the Government to issues raised on behalf of taxpayers.

Official documentation

The Stamp Duty Land Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2005 SI 2005/1868 and the Tax Avoidance Schemes (Information) (Amendment) Regulations 2005 SI 2005/1869 were made on 11th July 2005 to come into force on 1st August 2005. On the same day HMRC issued Guidance Notes entitled 'Disclosure of Stamp Duty Land Tax (SDLT) Schemes' intended to assist promoters and users of SDLT schemes to understand how the new rules will apply.

The new rules in a nutshell

The extension of the disclosure rules to SDLT applies where the subject-matter of the arrangements is non-residential or mixed property with a market value of at least £5 million. The guidance notes emphasise that the extension to SDLT is not restricted to new and innovative tax planning schemes. The 'confidentiality', 'premium-fee' and 'off-market test' filters which apply to employment and financial products do not apply to SDLT. Failure to notify a prescribed arrangement within five days of the due date will incur the usual fine of £5,000 but, unlike the existing regime, disclosure will not require a user of the scheme to provide a reference number on his tax return. The sole purpose of the extension is to inform Stamp Taxes of commercial SDLT arrangements which are occurring in the marketplace. It is beyond the scope of this Item to provide a general explanation of the FA 2004 regime, except as is necessary to put the extension to SDLT into context.

Which schemes must be disclosed?

The FA 2004 part 7 rules require disclosure of a tax scheme only where:-

- its use might be expected to give rise to a tax advantage;
- that tax advantage is the main benefit, or one of the main benefits, which might be expected to arise from using the scheme; and
- the arrangements fall within a description prescribed in regulations.

The prescribed arrangements in relation to SDLT are those: whose subject-matter does not consist wholly of residential property; in respect of which the aggregate value of the chargeable

interest in such property is at least £5 million at the time any requirement to notify arises; and which fall outside certain exceptions listed in the regulations.

Is a scheme notifiable?

Only if the answer to all the following questions is 'yes' will a scheme be notifiable:-

- (a) Are there arrangements or a proposal for arrangements? The primary legislation defines 'arrangements' widely to include any scheme, transaction or series of transactions. Note that this definition is wider than the concept of 'linked transactions' in FA 2003 s108.
- (b) Would use of the arrangements be expected to result in an SDLT advantage for any person? Para 4.3 of the main guidance explores the concepts of 'tax advantage' and 'main benefit'.
- (c) Would that advantage be expected to be the main benefit, or one of the main benefits, arising from the arrangements? Para 1.2 emphasises that the disclosure rules are aimed at tax schemes expected to result in tax advantages which exploit loopholes and so on in ways not intended by Parliament.
- (d) Will the arrangements be used wholly or partly for non-residential property?
- (e) Is the aggregate market value of all the chargeable interests in that non-residential property at least £5 million?
- (f) Are the arrangements outside the exceptions listed in the regulations? The regulations contain a list of six steps A – F (set out below). Schemes which consist of a single step or certain combinations of the steps (only) do not have to be notified. The Guidance Notes warn that the fact that any particular scheme is excepted from disclosure should not be taken to imply that HMRC either find the scheme acceptable or that they accept that it works under current law. They refer to the steps as 'existing building blocks': HMRC are not interested in the existing building blocks in themselves, rather in the ways in which they are put together to form more complex products. Any schemes which combine one or more of the listed steps with an unlisted step (where the unlisted step is necessary for securing the SDLT advantage) are not excepted from disclosure.

The listed steps

- Step A:** The acquisition of a chargeable interest in land by a special purpose vehicle ('SPV').
- Step B:** A single claim to relief from SDLT under various specified provisions in FA 2003 (e.g. group relief, reconstruction relief, acquisition relief and charities relief).
- Step C:** The sale of shares in an SPV which holds a chargeable interest in land to a person to whom neither the SPV nor the vendor is connected.
- Step D:** Not electing to waive the exemption from VAT (in VATA 1994 Sch 10 para 2).
- Step E:** Arranging the transfer of a business connected with the land which is the subject of arrangements in such a way that it is treated for VAT purposes as the transfer of a going concern.
- Step F:** The creation of a partnership (as defined for SDLT purposes) to which the property subject to a land transaction is to be transferred.

Combinations of steps

Rule 1 under the SI 2005/1868 provides that arrangements involving steps B, D, E and F are excluded arrangements unless rule 2 applies. Rule 2 provides that arrangements are not excluded arrangements if they -

- (a) include all, or at least two, of steps A, C and D; or
- (b) involve more than one instance of step A, C or D.

Para 1.2.21 of the Guidance Notes confirms HMRC's acceptance that step B includes steps taken or not taken with the intention of ensuring that, within the context of the withdrawal of group, reconstruction or acquisition relief:-

- the purchaser ceases to be a member of the same group as the vendor; or
- control of the acquiring company changes; or
- arrangements for either of the above events are entered into;

on or after the end of the period of three years beginning with the effective date of the relief, rather than before the end of that period.

Who must disclose the scheme?

As with the other direct taxes, the requirement to notify normally falls on the promoter of the scheme. There are three exceptions to this, so that the obligation falls on the user where:-

- (a) the promoter is off-shore and does not disclose the scheme;
- (b) there is no promoter (ie the scheme has been designed in-house); and
- (c) the promoter is a lawyer prevented by legal professional privilege ('LPP') from making a full disclosure of the information required. However, the client can waive LPP sufficient to enable the lawyer to disclose.

Part 2 of the Guidance Notes provides further guidance for promoters and part 3 further guidance for users of SDLT schemes.

When must the scheme be disclosed?

The general time limit rule for the other direct taxes applies to SDLT schemes as well. For SDLT schemes a special timing rule applies to (a) users of 'in-house' schemes and (b) users who are required to notify a scheme as a consequence of LPP applying to the promoter (a lawyer). The special rule is that the user of the scheme must notify it within a 30-day period, beginning with the day after the day on which the user enters the first transaction forming part of the arrangements.

What information is required?

The information required is the same as for the other direct taxes, viz briefly:-

- Name of the promoter or other person required to make the disclosure. Promoters do not have to provide details of clients or users of the scheme.
- Details of which provision in the arrangements regulations makes the scheme notifiable. For SDLT schemes it will be sufficient to say 'the SDLT regulations'.
- A summary of the proposal/arrangements and the name by which it or they are known.
- Information explaining the elements and how the expected tax advantage arises.

- The statutory provisions on which that tax advantage is based.

Notification to the Anti-avoidance Group (Intelligence) ('AAG') must be made using the correct form. For SDLT schemes AAG will issue a reference number to promoters, solely to help the promoter to identify the scheme to internal and external stakeholders (to ensure that the same scheme is not disclosed more than once, whether by the same promoter or by the scheme's co-promoters). However, there will be no statutory obligation on the promoter to provide a user with a reference number (and indeed HMRC recommend that promoters do not pass on reference numbers to users and emphasise that the user is not required to notify the number to HMRC in any way).

Penalties for failure

A person who fails to notify a disclosable scheme will, as with the other direct taxes, be liable to an initial penalty of up to a maximum of £5,000. Continuing failure to notify after the initial penalty has been imposed will attract a further daily penalty up to a maximum of £600 per day. No penalties will apply in relation to reference numbers. Para 1.6.3 of the Guidance Notes states that the AAG will do everything possible to explain the rules and assist promoters and others to meet their obligations to ensure HMRC receives disclosures, but will pursue penalties for non-disclosure where necessary.

Commencement date

Promoters and users will not have to notify a scheme where the normal trigger point for disclosure occurs before 1st August 2005. However, if a new client is advised to use the same scheme on or after 1st August there will be a new trigger point and the promoter must notify the scheme. Generally, therefore, the FA 2004 formula applies. So persons are not required to notify if:

- for promoters required to notify proposals, the 'relevant' date of the proposal falls before 1st August 2005;
- for promoters required to notify arrangements, the date on which they first become aware of any transaction forming part of the arrangements falls before 1st August 2005;
- persons other than promoters required to notify arrangements, the date of any transaction forming part of the arrangements falls before 1st August 2005.

(HMRC Guidance Notes 'Disclosure of Stamp Duty Land Tax (SDLT) Scheme 11.7.05)

COMMENT: Para 4.3 of the Guidance Notes is 'recommended reading' on the meaning of 'tax advantage': not surprisingly, the concept is interpreted very widely.

It is possible that on top of the 'excluded arrangements' set out in the schedule to SI 2005/1868, a 'white list' of types of arrangements to be agreed by HMRC with professional bodies may be issued to prescribe certain further types of arrangement which do not require disclosure.

Given the possible very wide scope of the meaning of 'tax advantage' and the limited types of arrangement that are excluded from the new disclosure regime, it is likely that HMRC will find themselves on the receiving end of very large numbers of disclosures, to avoid the risk of a fine of £5,000, the vast majority of which will hardly represent 'innovative tax planning'.

8. Nil-Rate Band Discretionary Trusts and SDLT

Context

Our Bulletin Issue No 13 Spring 2005 reported on the IR Statement issued on 12th November 2004 about the SDLT implications of adopting, alternatively, the debt route and the charge route in constituting the nil-rate band of the first spouse to die. Although HMRC take the view that the debt route clearly involves an SDLT liability for the surviving spouse (insofar as the IOU is given in consideration of her receipt of a share or larger share in her late husband's interest in the house), that should not be simply accepted. Of course, it is always possible to draft the documents such that that is the case, but equally it is possible to ensure, by careful drafting, that it is not. Indeed, it appears that at least one if not more solicitors have achieved the agreement of Stamp Taxes that under the IOU route as adopted no SDLT is payable. And the analysis is characteristically clearly set out in the latest edition of James Kessler QC's *Drafting Trusts and Will Trusts*.

Constituting the IOU by a spouse undertaking

The trustees of the discretionary Will trust have a right to a cash sum. That right is certainly not a chargeable interest for SDLT purposes. If it can be regarded as an interest in land it is a 'security interest' for SDLT purposes which is expressly exempt from SDLT (FA 2003 s.48(2)(b)). That cash sum might be constituted by an undertaking by the surviving spouse (say the widow) to pay the amount. Importantly, she does not become entitled to receive her late husband's share in the land by virtue of the undertaking. She was entitled to that land anyway under the Will. All that happens by giving the undertaking is that her entitlement has ceased to be subject to the burden of the trustees' rights under the Will. Her undertaking has freed the land from the burden of paying the nil-rate band legacy. In particular, her undertaking does not involve an acquisition of a chargeable interest, so does not occasion an SDLT liability.

A land transaction does occur when the PRs transfer the husband's interest in the land to the spouse, through an assent, but that is exempt under FA 2004 Sch 3 para 3A – unless of course there is any consideration. But the widow is not giving consideration for an interest in land. She gives her undertaking in consideration of the PRs exercising their powers and the extinction of the trustees' rights under the Will. At most her receipt of the land would be in consequence, but not in consideration, of her undertaking. She acquires the land as a residuary legatee and not as purchaser.

(Drafting Trusts and Will Trusts by James Kessler QC, Update April 2005 to Nil-rate Band Trusts Appendix 4)

COMMENT: This is a welcome clear analysis of how the IOU scheme documentation should be drawn so as to avoid an SDLT charge. It may be thought preferable in general terms to go the charge route, as adding greater substance to the arrangement so as to be able more easily to satisfy HMRC Capital Taxes following the second death (and, in a case where there were lifetime gifts from the survivor to the deceased and FA 1986 s103 is likely to present a problem in denying a deduction for the debt on the second death, preserving the analysis that s103 does not apply, because the liability is not owed by the surviving spouse but by the trustees of a Will trust established by the first to die). However, the simple IOU route remains useful in

straightforward circumstances. Provided both the initial documentation and the subsequent implementation of the scheme are carefully done, its effectiveness should be accepted following the second death. The spectre remains of HMRC challenging one or two perceived vulnerable debt routes before the Special Commissioners, though at the time of writing no firm information is known.

MISCELLANEOUS

9. Residence: Failure to Establish Cessation of Residence and Ordinary Residence in the UK

Context

The issue in this case was whether the appellant airline pilot had done sufficient to become both not resident and not ordinarily resident in the UK for tax purposes.

Shepherd v HMRC; the facts

Mr Shepherd was a British subject, an airline pilot employed by a British company flying long haul flights which started and ended at Heathrow. In 1987 Mr and Mrs Shepherd purchased a house in the UK in their joint names where they lived with their son. Mr Shepherd and his wife subsequently separated, albeit they both continued to live in the same house. Mr Shepherd, who had to retire on 22nd April 2000, decided to retire overseas and in October 1998 rented a flat in Cyprus and stayed in rented accommodation there until he purchased an apartment in 2002. Mr Shepherd continued to pay the mortgage on the family home, where he remained on the electoral roll, and paid all the household bills and had his correspondence sent there. He still stayed in the family home before and after each flight.

It appears that Mr Shepherd spent 180 days in the tax year out of the UK on flights, 77 days in Cyprus where he rented a furnished flat and 80 days in the UK in the family home.

On 22nd April 2000 Mr Shepherd retired.

In May 2003 HMRC issued a notice of determination that for the year of assessment 1999/2000, Mr Shepherd was ordinarily resident in the UK. Mr Shepherd appealed, arguing that in October 1998 he had deliberately set up a separate house in Cyprus, where he lived with a sufficient degree of continuity, and thereafter there was a material change in the character and quality of his presence in the UK as he ceased to be resident here and became a visitor, only visiting the family home for work purposes. HMRC contended that there was no distinct break in October 1998; Mr Shepherd remained in the UK for a settled purpose, namely to perform the duties of his employment and to continue to see his wife, family and friends.

The decision (SpC: Dr Nuala Brice)

The Special Commissioner found on the facts that after October 1998 the appellant's presence in the UK was substantial and continuous, and there was no distinct break.

Mr Shepherd continued to work in the UK, stayed in the family home and visited friends. His presence in Cyprus after October 1998 was, at the most, for occasional residence abroad so in spite of From October 1994 he less than ninety days a year in the UK. At least until 5 April 2000 he continued to be resident and ordinarily resident in the UK, despite voluntary absences to fly in the course of his employment, or to go to Cyprus, or go on holiday. Accordingly, he was liable to income tax for the year 1999/2000. The appeal was dismissed.

(Shepherd v HMRC SpC 484 20.6.05 [2005] SWTI Issue 29)

COMMENT: It seems that this is not really a very surprising decision. Mr Shepherd had failed to become neither resident nor ordinarily resident in the UK, essential preconditions for the IR 20 tests. Had proper professional advice been given to Mr Shepherd before he attempted his 'fiscal flit' from the UK, the outcome might have been rather different. Maybe, however, given his continuing obligations to the airline before he retired, it might have been difficult to achieve the result he wanted. At the very least, however, on moving to a jurisdiction which has a treaty with the UK, one needs to establish treaty residence in that other country as quickly as possible.

10. Settlement Provisions: Disclosure for 2004/05

Context

A number of professional bodies issued guidance on 23rd November 2004, followed up on 7th January 2005, on the completion of SA returns for 2003/04 in relation to the settlement provisions of TA 1988 s.660A. The Revenue on 24th December 2004 issued guidance notes for taxpayers completing SA returns generally in the light of the Court of Appeal judgement in *Langham v Veltema*.

The Court of Appeal is to hear the taxpayer's appeal in *Jones v Garnett* on 29th and 30th November 2005. A press release has been issued by the CIOT on behalf of the Tax Faculty, the CIOT, the ACCA, ICAS, ATT and AAT to help with self assessment for 2004/05 in the light of the *Jones v Garnett* litigation. The press release was issued at a time when the CA hearing had been set for 17th and 18th January 2006 and so the decision was unlikely to be available before the filing deadline of 31st January 2006.

The function of the latest PR is to highlight cases where the High Court decision should be applied and to assist advisers in distinguishing cases where the facts may differ, pointing also to the relevant considerations when preparing SA returns for affected clients for 2004/05.

What types of situations are affected?

The High Court decision (see our Tax Bulletin No 14 Summer 2005 Item 9.) would apply to a company in the following circumstances:

- the company has a low capital value;
- the spouse subscribed for the share;
- the spouse does either no work at all or relatively little work (Mrs Jones having done some 4 to 5 hours a week);
- the remuneration paid to the main income generator is below the market rate for the job (Geoff Jones having drawn £6,000 salary out of fee income generated of £90,000); and
- the shareholders receive a dividend.

It is likely also that in cases where the share was given to rather than subscribed by the non-working spouse, but other factors are the same, the legislation in what is now ITTOIA 2005 s615 and following will apply.

Taxpayers in a similar position to Geoff and Diana Jones

Such taxpayers have three possible options open to them:-

(a) Assess by reference to the settlements legislation

The issue here is what happens if *Jones v Garnett* is finally decided in favour of the taxpayer. If this happens on or before 31.1.07, taxpayers may amend their income tax returns by that date reflecting the fact that the settlements legislation does not in fact apply. However, if the case is not finally settled until after then, 2004 returns cannot be amended. While in theory taxpayers could make an error or mistake claim under TMA 1970 s33, it is possible that HMRC will not accept such claims on the grounds that (within s33(2A)(a)) the return was made in accordance with the understanding of the law at that time.

(b) Take a view that the case will be overturned and disclosing

It is interesting that Lloyd LJ, in allowing the taxpayer to make an appeal, said that he was satisfied *'that it is a point on which there are substantial arguments either way and that there are therefore reasonable prospects of success on the appeal'*. A taxpayer with this knowledge would arguably not be acting unreasonably in self assessing on the basis that the appeal will succeed, providing that this is made clear in the return. In the recent case of *National Westminster Bank Plc v Spectrum Plus*, the HL said on 30.6.05 of the lower Court's decision: *'It was a first instance decision and cannot have been regarded as definitely settling the law in that field.'*

To ensure full disclosure, a clear white space note should be made to the effect that the High Court decision is not being followed. This should preclude the ability of HMRC to use their discovery powers in the future in relation to tax year 2004/05. Possible wording could include: *'Dividends of £X were received by Mrs Y which may be assessable on me under the settlements legislation found in s619 onwards of ITTOIA 2005. These dividends have not been included on my tax return pending the outcome of the appeal in Jones v Garnett'. Revenue guidance indicates that the settlements legislation may apply but the return has been completed on the basis that it does not.*

Clients should be alerted that interest will arise on unpaid tax if the case is finally resolved in favour of HMRC, not to mention the possibility of penalties if it is considered that the position taken was not reasonable. Equally, clients should be made aware of the implications of such a white space note leading to an enquiry in relation to previous years.

(c) Take a view that the case will be overturned and not disclosing

A taxpayer might take a different view of the law from that stated by the High Court and, on the footing that the High Court decision will be overturned, they are entitled technically to self assess without disclosing. However, if HMRC are finally successful in *Jones v Garnett*, the taxpayer would then need to repair the return or otherwise disclose if the period for a repair had ended. If this course of action is taken, penalties are highly likely to be imposed, plus of course interest. This route would also provide no protection from discovery. This course of action is not recommended by the professional bodies.

Earlier years

While HMRC have been asked to provide guidance on how they will operate in relation to earlier years following *Jones v Garnett*, there has to date been no official information further to the document issued on 18th November 2004 entitled 'A Guide to the Settlements Legislation for Small Business Advisers'.

Where there is sufficient evidence to suggest that HMRC would agree that the legislation does not apply

In such cases the adviser should still consider HMRC's view as set out in their published guidance. In some cases the guidance will indicate that HMRC will agree that the settlements legislation does not apply. In such cases it will be possible to continue to self assess without reference to the settlements legislation (as it will not be in point) and there will be no need for a white space note. It is important to remember a comment from Park J in the high Court: '*If a husband and wife set up a joint company and run it together ... it does not follow from my judgment in this case that the husband is going to be taxed on the wife's dividends.*' The sort of factors which would help to show that the settlements legislation did not apply might include:

- the payment of a market salary to the key worker;
- appropriate capital value in the business or evidence of sufficient involvement by the 'less active spouse' to justify the dividend.

However, no one fact is decisive and the overall arrangement must be carefully considered for evidence of retained interest on the part of the key worker and bounty.

Where the situation can be distinguished from Arctic Systems, but where HMRC may believe the settlements legislation applies

Here a view must be taken on the correct level of disclosure required. The CA decision in *Langham v Veltema [2004] STC 544* seems to make it clear that, to avoid discovery assessments in later years, the precise point on which protection from discovery is sought must be brought to the attention of the officer dealing with the taxpayer's personal tax affairs. The professional bodies do not dissent from the initial HMRC guidance on this point, issued on 23.12.04. This stated: '*... the guidance on discovery is that taxpayers should enter in the Additional Information space comments to the effect that they have not followed the Revenue guidance in respect of s660A ... protection can be achieved by noting that 'Revenue guidance indicates that s660A may apply. No adjustment has been made'*'.

Such a course would then leave it open to HMRC to decide whether or not to make an enquiry within the normal enquiry window. Once the window has closed for any particular year, the taxpayer may be protected from discovery '*unless the stance adopted is wholly unreasonable*'.

Alternatively, the taxpayer may prefer to return the actual income without further disclosure explanations and resist a challenge from HMRC that the settlements legislation applies, if one is made within the normal enquiry window or within the 5 years and 10 months allowed for a discovery assessment.

The professional bodies take the view that there is no tax law requirement for a taxpayer to indicate where he has interpreted a doubtful issue in his favour. Obviously, this presupposes

that the return is correct and complete and that the non-application of the settlement provisions to reallocate income is a tenable stance.

Record of discussion with clients

Advisers should discuss with their clients the possible application of the settlements legislation where the position is unclear. They should weigh up the comparative disadvantage of provoking an enquiry with a possible discovery assessment covering earlier years, if either the CA judgement further extends the decision in HMRC's favour or subsequent court cases are decided in favour of HMRC's interpretation of the legislation. It is important that there is a very clear record of the discussions with the client, with either a detailed file note or preferably the position clearly explained in a letter to the client, with written confirmation from the client as to the basis on which the tax return is to be completed (including, in particular, the client's agreement to the wording of any entry to be made in the white space).

Civil partnerships

In future, the issues raised in the guidance note will be relevant to some persons registering a partnership under the Civil Partnership Act 2004 which takes effect from 5th December 2005.

Enquiry insurance

Some practices will operate arrangements under which the costs of handling an enquiry are covered by insurance. The professional bodies strongly recommend that the adviser discusses the approach which his/her practice will take to return disclosure in this area, to ensure that their clients remain covered by any insurance.

(CIOT press release 15.9.05)

COMMENT: In our view, the Court of Appeal is likely to uphold the High Court decision in favour of HMRC. In particular, if the battle is again to be joined largely on the 1961 CA decision in *Crossland v Hawkins* 39 TC 493, it might seem surprising that there has not been a leapfrog direct to the HL.

What does seem clear is that the case cannot really be said to be the 'simple application of well-established principles' as it was characterised in Park J's judgement. In any typical such husband and wife company, the working spouse should at least ensure that he or she is paid on what can be defended as a 'market value' salary.

However, the more interesting issue is whether dividends paid in the *Jones v Garnett* type case might fall within F(No 2) A 2005 Sch 2 para 18, that is, could the payment of either a series of dividends or perhaps just one dividend be said to be something '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' (as substituted in ITEPA 2003 s.447(4))? The issue arises not only in a *Jones v Garnett* sort of case (and then for the dividends paid to both husband and wife), but also in a simple case where a single shareholder chooses to take income out of the company by dividend rather than remuneration and is paid less than a market rate salary.

The (cautious) conclusion to which we come is that, while the question is obviously a tricky one, it must be dangerous to assume that freedom from NIC will be achieved in such cases in future. HMRC seem to want to assess NIC on amounts received by employees with employment-related securities insofar as earnings are below market rate (even if the legislation has to be tightened up, no doubt with effect from 2nd December 2004, to achieve that).

11. Fraud: New Civil Investigation Procedures

Context

Both HM Customs and Excise and the Inland Revenue had procedures for tackling suspected serious tax fraud using civil powers. The former Inland Revenue's Hansard procedures and all former Customs & Excise Civil Evasion procedures have been replaced with a new single Civil Investigations of Fraud procedure for HMRC. (The only exception is the Customs Duties Civil Evasion Penalties applied to travellers at port and airport controls.)

1 September 2005 start and new Code of Practice 9 (2005)

The new Civil Investigation of Fraud procedure came into effect on 1st September 2005 for new cases, with a new Code of Practice 9 (2005).

Existing cases will be worked to a conclusion under the old Hansard procedures (Code of Practice 9), New Approach or C&E Notice 730.

Initially the new procedure will be used only by officers serving in HMRC Special Civil Investigations. Use by other specialist teams within HMRC is under consideration.

The changes

- The new procedure is wholly civil, removing the threat of prosecution for the original tax offence - a change from the Inland Revenue's Hansard procedure.
- HMRC will retain the option to consider prosecution for a materially false disclosure or materially false statement with intent to deceive.
- Interviews will no longer be conducted under caution and tape-recorded.
- Investigations under the new Civil Investigation of Fraud procedure will cover both direct and indirect taxes where appropriate.

Outline of the Civil Investigation of Fraud procedure

Where HMRC suspect serious tax fraud and decide to proceed via a civil rather than a criminal investigation, the taxpayer will be given one opportunity to secure maximum benefit by making a full disclosure of all irregularities within the direct and indirect tax regimes. If they take that opportunity, the investigation will proceed more quickly, efficiently and advantageously for both the taxpayer and HMRC.

If a taxpayer decides not to make a full disclosure and co-operate, HMRC will conduct their own investigation, using statutory information powers if necessary. If irregularities are discovered they will issue formal assessments and pursue collection of unpaid tax with interest. Any penalties due are likely to be significantly higher, to reflect the fact that the taxpayer did not take the opportunity given to them to disclose.

Once the decision by HMRC has been made to follow a civil route for investigation and the procedure is offered to the taxpayer, HMRC retain no underlying threat of prosecution for the original tax loss.

Prosecution for tax fraud

HMRC reserve complete discretion to pursue a criminal investigation with a view to prosecution where they consider it necessary and appropriate. Where HMRC decide to use the Civil Investigation of Fraud procedure they will not prosecute for the original tax offence. However if materially false statements are made or materially false documents are provided with intent to deceive, HMRC may conduct a criminal investigation with a view to a prosecution of that conduct.

Single meetings to discuss indirect and direct tax matters. Once the new procedure is introduced, where suspicions of irregularities cut across direct and indirect taxes, a single meeting will be held to cover all regimes. During this meeting it will be made clear to the taxpayer whether questions are relevant to direct taxes, indirect taxes or both.

Disclosure reports

Any disclosure reports prepared by professional advisers will now be expected to cover direct and indirect tax irregularities in the same document. HMRC anticipate that there will be costs savings and other benefits to the taxpayer in submitting a single disclosure report.

Civil Investigation of Fraud and the Human Rights Act

HMRC believe that the new procedure is compliant with the Human Rights Act. The civil fraud processes previously operated by both departments have received considerable scrutiny in terms of Human Rights and, in particular, article 6 - Right to a Fair Trial. The views of the courts in the lead Human Rights Act rulings of *Han & Yau* and *Gill & Gill* together with advice from leading counsel have provided the principles for designing the new procedure. The recent case of *Khan v Commissioners of Customs and Excise (2005)* has endorsed these principles and safeguards have been built into the new procedures.

Consultation

This change is being made after consultation with relevant representative bodies.

(HMRC business brief 16.9.05)

COMMENT: The new regime and new COP 9 procedure does seem a sensible rationalisation but of course they depend on full disclosure and co-operation by the taxpayer and HMRC reserve to themselves complete discretion to pursue a criminal investigation to prosecution where they consider it necessary and appropriate.



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

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