

PRACTICE UPDATE

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1. Dividend oddities

Recent case law has highlighted two interesting scenarios involving dividend payments.

Recategorised dividends

In *Stirling Investments v HMRC* [2010] VKFTT 61 (TC) TCO0374, a VAT Case, a husband and a wife partnership were also director shareholders of a company. The partnership invoiced the company for a management charge of £525,000 plus VAT. However, the company later sought to argue that the management charge was erroneous and that the payment represented dividends. The issue in the case was whether or not a taxable supply had been made by the partnership. HMRC contended that the payment by the company to the partnership was indeed in respect of management charges.

The tribunal concluded, on the facts of the case, that the situation had arisen due to an accounting error by the appellants and their finance director. It held that no taxable supply occurred, and therefore allowed the taxpayer's appeal.

At first glance, the decision in this case presents some interesting tax planning opportunities. It suggests that transactions can be recategorised with the benefit of hindsight. Unfortunately, this is unlikely to be the situation in most cases. The tribunal pointed out that what occurred was "... a true error as opposed to a situation where a party has intended to characterise a transaction as a supply but

is now of the view that it was not the most beneficial interpretation." The tribunal added: "Clearly it was the intention of all relevant parties...that the £525,000 should be released to the partnership as a dividend and by way of a distribution of profits..." "No substantial management services have been delivered by the partnership to the company..."

However, what this case does illustrate is that it can be possible to amend transactions to their true nature, where there has been a genuine error in the original transaction, with no dishonesty or intent to deceive.

NIC on dividends

One of the advantages of dividends over salaries or bonuses in remuneration planning has traditionally been that there is normally no NIC on dividends. However, HMRC successfully sought a Class 1 NIC charge on distributions in *PA Holdings Ltd v HMRC (and related appeal)* [2009] UKFTT 95 (TC), TC00063.

The case broadly involved arrangements to re-route employee bonuses so that they were paid as company dividends and would therefore be taxable as distributions. The stated aim of the arrangement was "to motivate and encourage employees in the performance of their duties."

The tribunal held that the amounts paid to the employees were both distributions and earnings, but that "Schedule F trumps Schedule E" (in other words, that distribution treatment takes precedence

over an employment income charge). However, having found as a fact that the payments were earnings, the tribunal concluded that the payments were liable to Class 1 NIC.

The PA Holdings case was appealed, and the decision has yet to be released at the time of writing. However, it should be noted that the dividends in that case were part of a bonus planning arrangement for the employees and shareholders. It seems unlikely that HMRC would seek to impose a Class 1 NIC charge on dividends on 'plain vanilla' shares to shareholders in family or owner-managed companies, where the dividends are properly voted and paid, and the individual already receives adequate remuneration for any duties performed. Of course, a change in the law to impose Class 1 NIC charge in the future cannot be ruled out.

2. Record keeping

'New HMRC powers' is a phrase we have all become accustomed to hearing over the last few years. Among those powers is the facility for HMRC to make regulations specifying the records and supporting documents which must be kept, and the period for which they must be retained.

HMRC's record keeping powers were introduced for income and corporation tax purposes in Finance Act 2008 (s 115, Sch 37), and apply with effect from 1 April 2009. They were extended (in FA 2009, s 98, Sch 50) to include various other taxes and duties, including stamp duty land tax. The legislation enables HMRC to make new regulations specifying which records must (and need not) be kept, including by way of a notice.

Existing requirements

For individuals carrying on a trade, profession or business alone or in partnership, specific record keeping requirements are already set out in TMA 1970, s 12B. For a company, there is broadly a requirement to keep records of receipts and expenses in respect of its activities, and records of sales and

purchases for trades involving goods (FA 1998, Sch 18 para 21). In addition, company law has its own record keeping requirements (CA 2006, ss 386-389).

HMRC recently published a tax helpsheet 'Keeping records for business – what you need to know', which provides a useful summary of which records must and/or should be kept by businesses, as well as by employers and for CIS purposes: see www.hmrc.gov.uk/factsheet/record-keeping.pdf (as to record keeping generally, see www.hmrc.gov.uk/record-keeping/index.htm). The helpsheet also outlines the existing time limits for keeping records, although there is to be a general alignment of time limits across the various taxes eventually.

Capital gains

There is a potential problem for capital gains purposes in terms of record keeping if assets have been held for a long time. HMRC's Compliance Handbook (at CH14650) states that a person '...will need to keep and retain records that will enable them to make a correct and complete return of the capital gain or capital loss...'

This record keeping requirement, according to HMRC's guidance, extends to '...records relating to the acquisition and improvement of a chargeable asset.' This would indicate that taxpayers may need to keep records for many years, perhaps as far back as March 1982 (or possibly to 1965 for some disposals in earlier years).

Of course, in practice records are often lost or destroyed, or may simply not be kept over so many years. Estimates would therefore need to be considered in those cases.

No document, no problem?

Documentation will often be needed to evidence events or transactions which have taken place. For example, HMRC may request company minutes of board meetings to establish decisions such as the voting of directors' remuneration.

Interestingly, HMRC guidance appears to accept that board minutes will not necessarily be available. This follows a (non-tax) case *Re Duomatic Ltd* (1969 2 Chancery 365). The HMRC guidance states (albeit in the context of the Companies Act 1985) that if directors' remuneration is approved by the company's shareholders entitled to attend and vote at a general meeting, this has the same effect as a resolution passed by the company in a general meeting (EIM42300).

In *re Duomatic Ltd*, director shareholders of the company received remuneration, but no resolution was ever passed, and none of the directors had contracts of service. The company went into voluntary liquidation, and the liquidator sought (among other things) repayment of the directors remuneration. The court held that where it can be shown that all the shareholders with the right to attend and vote at a general meeting had assented to something which a general meeting could carry into effect, the assent was as binding as a resolution in general meeting.

The *Duomatic* principle may be particularly helpful in the context of small family companies, where shareholder decisions are often not documented. Of course, for company law purposes it will still be necessary to ensure that any Companies Act 2006 requirements are satisfied.

3. Transactions in securities

When dealing with company reorganisations and some business sales, it is generally good practice to apply to HMRC for clearance (under ITA 2007, s 701) that the anti-avoidance rules regarding 'transactions in securities' will not apply to treat a capital transaction as giving rise to a potential income tax liability. The rules were originally introduced in the 1960s, and their complexity and lack of clarity previously caused a great deal of uncertainty in many cases.

However, the 'old' transactions in securities provisions were replaced in Finance Act 2010 with simplified legislation. This follows an 'anti-avoidance simplification review'. HMRC issued a 65 page consultation document ('Simplifying Transactions in Securities Legislation') on 31 July 2009, which was the subject of my article 'New and Improved' in Taxation magazine on 21 October 2009.

The new rules

The 'new' transactions in securities rules apply to all close companies (replacing 'relevant company' in the old rules). The legislation was intended to be targeted more effectively at arrangements involving tax avoidance, using a new and more specific definition of an income tax advantage. There is also a new exemption covering fundamental changes in ownership of shares in a close company.

The 75% test

The 'fundamental change of ownership' exemption excludes circumstances otherwise caught by the anti-avoidance rules. For vendor shareholders, the exemption broadly applies if at least 75% of the close company's ordinary share capital (with an entitlement to at least 75% of distributions and voting rights) is held by one or more unconnected persons (who were also unconnected persons for at least the previous 2 years).

HMRC's stated intention for this new exemption is to remove the need for as many clearance applications, as it was previously HMRC's practice to grant clearances in most cases where there was a 75% change of ownership.

Despite HMRC's stated intention to narrow the transactions in securities rules to and target them more at anti-avoidance situations, the definition of 'transactions in securities' itself is wide enough to include everyday transactions within its definition, including the sale of shares and subscriptions for new shares. An awareness and understanding of the rules is therefore important.

HMRC guidance on transactions in securities in the Company Taxation Manual (at CTM36800-CTM36885) is based on the 'old' rules at the time of writing. HMRC has produced detailed guidance on the 'new' transactions in securities rules for publication in the Company Taxation Manual, which will probably be released into the public domain shortly.

Detailed guidance is an unfortunate but probably necessary consequence of the brevity of the new legislation, which is written in the tax law rewrite style. Nevertheless, the guidance cannot cover all situations and is non-statutory in any event, so clearance applications to HMRC will still be necessary in many cases.

4. IHT – deliberate omissions

For Inheritance Tax (IHT) purposes, the general rule is that a transfer of value requires positive action by the person making it, such as the gift of an asset. However, in certain circumstances a failure to take positive action is treated as a disposition as well. In particular, the deliberate omission to exercise a right can be treated in this way (IHTA 1984, s 3(3)).

A recent tax case considered this provision, in the context of pension rights. In *DM Fryer & Others (Personal Representatives of Patricia Arnold Deceased) v HMRC* FTT [2010] UKFTT 87 (TC), TC00398, the executors appealed against a determination by HMRC that the deceased, Mrs Arnold, had made a disposition under s 3(3) by deferring her retirement benefits under a pension policy. The normal retirement date under the policy was 8 September 2002 (her 60th birthday), but she was entitled to take benefits at any time between her 50th and 75th birthdays. In April 2002, Mrs Arnold was diagnosed with a serious illness, and died on 30 July 2003 without having taken retirement benefits under the policy.

The tribunal held on the particular facts of the case that Mrs Arnold had omitted

throughout her lifetime to exercise her pension rights, and that the omission had therefore continued until her death. The burden of proof was on the executors to show that the omission had not been deliberate. However, it was held that the deceased's omission was deliberate, and had diminished her estate. Furthermore, the tribunal considered that Mrs Arnold's estate had been diminished by her omission to exercise the pension rights, which increased the value of settled property (i.e. the payment of death benefits to the trustees of a discretionary trust).

For IHT purposes, a disposition is not a transfer of value if it is not intended to confer a gratuitous benefit (i.e. within IHTA 1984, s 10). However, the tribunal held that s 10 did not operate in Mrs Arnold's case to exempt her omission to exercise a right from an IHT charge (under s 3(3)). There was, among other reasons, an intention to confer a gratuitous benefit on the beneficiaries of the trust, in the form of death benefits.

The tribunal assessed the value of the right to take the retirement benefits at 30 July 2003, being the latest date at which Mrs Arnold could have exercised the right. Subject to certain variations in HMRC's Notices of Determination (including a change in the date of omission to exercise the rights from 8 September 2002 to 30 July 2003), the PR's appeal was dismissed.

Practical issues

The *Arnold* case raises some interesting IHT issues. It would seem that the pension policyholder is effectively 'on risk' from the date when he could first have drawn the pension until death. Each passing day that the pension is not drawn is a new occasion of omission.

The case also perhaps highlights the potential difficulty in valuing the amount of the disposition for IHT purposes as a result of the omission. As the tribunal pointed out in the above case, it was not the increase in the value of the trust

property that mattered, but the reduction in the value of the estate.

It should be noted that there is potential relief from an IHT charge under s 3(3) in respect of registered pension schemes in s 12 ('Dispositions allowable for income tax or conferring benefits under pension scheme) at sub-ss (2A)-(2G) if certain conditions are satisfied. However, the IHT rule on the omission to exercise a right is generally wide ranging, and care is needed when dealing with possible omissions.

Facing the tribunal

As an aside, it is also interesting to note that in the *Arnold* case the deceased's PRs were represented by an Independent Financial Adviser (IFA). The tribunal observed out that the IFA had no previous experience of appearing before tax tribunals, and commented: "This is a case where quite clearly it would have been appropriate for the Executors to be represented by counsel, or by someone else equally experienced in representing parties before the tribunal." It is probably fair to say that the tribunal's comments could equally apply in all but the most straightforward of cases.

New Edition of Practical IHT Planning book published



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was published during May. The publisher's advertisement for the book is below. You can order the book from TaxBookShop (www.taxbookshop.com) or directly from the publishers, Bloomsbury Professional (www.bloomsburyprofessional.com).

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