PRACTICE UPDATE

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MARK MCLAUGHLIN ASSOCIATES
Chartered Tax Advisers

6 Coleby Avenue, Peel Hall,
Manchester M22 5HH

T: 0161 614 9370 **F:** 0161 613 5268 **W:** www.taxationweb.co.uk
E: tax@markmclaughlin.co.uk **W:** www.markmclaughlin.co.uk

Mark McLaughlin Associates Ltd – Reg. in England No 6127272

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HOLIDAY OFFICE CLOSURES

The office will close for Christmas and New Year on Thursday 23 December 2010, and will reopen on Tuesday 4 January 2011. **SEASONS GREETINGS & BEST WISHES FOR 2011!**

1. What is a Partnership?

It will normally be straightforward to identify the existence of a partnership; the parties will invariably deliberately join together to form one. However, in practice life is not always so simple. For example, a joint venture may take on some characteristics of a partnership. HM Revenue & Customs (HMRC) may contend that a business is carried on in partnership, where there is no formal partnership agreement.

In *Phillips v CRC* [2009] UKFTT 335 (TC) TC00276, one of the issues was whether a working arrangement between two architects constituted a partnership, as HMRC contended. The First-tier Tribunal held on the particular facts of the case that a partnership existed. In doing so, the tribunal provided a useful summary of factors to consider in determining whether a partnership exists.

Law and guidance

It seems quite remarkable in this climate of legislative change that the starting point on partnerships is to consider law which is over 120 years old. The Tribunal in the *Phillips* case cited the statutory definition of ‘partnership’ in the Partnership Act 1890. Section 1(1) states: "Partnership is the relation which subsists between persons carrying on a business in common with a view of profit". This is also a starting point of HMRC's guidance on partnerships, in the Business Income Manual.

A mere assertion that a partnership exists is not conclusive evidence if there is no supporting evidence. However, even if a partnership agreement exists, HMRC do not consider this to be conclusive evidence in its own right (BIM72005). HMRC refers to section 2 of the Partnership Act 1890, which contains rules for determining the existence of a partnership. That section states that the sharing of gross income does not create a partnership (s 2(2)). By contrast, the receipt of a share of net profits is prima facie evidence of being a partner, although it is not conclusive in itself (s 2(3)).

The tribunal in the *Phillips* case considered that it was "very relevant" to consider whether the agreement between the two architects was to share gross revenues (which it considered would be a joint venture and not a partnership) or to share net revenues. The tribunal found on the facts that profits and not merely revenue were shared between them.

Partnership factors

The tribunal went on to consider various other factors in considering whether a partnership existed. This may provide a

helpful list of points in determining whether a partnership exists in other cases:

- *Profit sharing* - As indicated, the sharing of net profits (as opposed to gross income) is prima facie evidence of the existence of a partnership, although other evidence can displace it.

- *Letterheads, etc* - Business stationery indicating the parties to be partners may be persuasive evidence.

- *Power to bind* - If one of the parties has the power to bind the firm in its business with others, this is indicative of a partnership, unless that party has no authority to act for the firm in a particular matter (see PA 1890, s 5).

- *Lack of trust* - The tribunal in Phillips held that secretiveness between the parties was not necessarily inconsistent with the existence of a partnership, although it may be grounds for a party to terminate it.

- *Competition* - The tribunal noted that the Partnership Act provides for the duty of a partner not to compete with the firm, but held that this did not necessarily mean that there was no partnership in the circumstances of this case.

- *Sharing losses* - It was contended in *Phillips* that an agreement to share profits but not losses was inconsistent with partnership (nb the tribunal held that the loss sharing arrangements were inconclusive in this case).

- *Professional indemnity (PI) insurance* - The PI arrangements of the parties was considered in the *Phillips* case.

- *Warranty deed* - An architect warranty deed between a customer and the alleged partnership was produced as evidence in the Phillips case (although unfortunately for the taxpayer it related to the wrong period).

- *VAT registration* - The question of whether the business was VAT registered was considered in *Phillips*.

- *Previous bad experience* - The appellant in Phillips had been involved in another partnership which ended badly. However, the tribunal held even if he would have been reluctant to enter into another partnership, this did not mean that the relationship in question was not a partnership.

- *Profit share* - It was pointed out in *Phillips* that the appellant did not get a 50:50 share in the profits. However, the tribunal held that an unequal share of profits is not inconsistent with a partnership.

- *Sale of part of business* - The other 'partner' (Mr Blintiff) sought Mr Phillips' consent to sell part of the business, which is consistent with a partnership (however, the tribunal noted that he did not account to Mr Phillips for any of the sale proceeds, which triggered the end of the relationship). The tribunal did not consider this to be particularly strong evidence of the existence of a partnership.

- *Views of the parties* - Mr Phillips had sought to argue that there was a partnership when suing Mr Blintiff for a share of the business capital (but later maintained that there was no partnership when HMRC raised assessments as such). The tribunal considered that any view taken by Mr Phillips during the period in question (i.e. before his dispute with Mr Blintiff) to be of relevance, as "...a businessman can be expected to have a fair idea of whether he is in business with another person with a view to making money".

- *Partnership tax returns* - Partnership returns were submitted to HMRC for the business. The tribunal considered the existence of partnership returns to be of value in showing that the signatory (Mr Blintiff) believed at the time that it was correct to make the

return on the basis that the relationship was a partnership.

- *Partnership accounts* - Accounts for the partnership were produced. Some sets of (draft) accounts were produced after the 'partnership' ceased to exist. The tribunal did not find them of any use in showing whether or not a partnership existed. However, it was considered relevant that one of the parties (Mr Blintiff) had instructed accountants to prepare partnership accounts

- *Individual tax returns* - The tribunal in Phillips found it to be "of even more relevance" than the partnership accounts that the appellant's tax returns disclosed the existence of the partnership, and that they had indicated that he was a partner.

The tribunal concluded that Mr Phillips and Mr Blintiff shared net profits and that this was prima facie evidence of a partnership between them.

HMRC will no doubt point out that the existence of a partnership or otherwise depends on the specific facts of each case. However, the above list of indicators from the Phillips case should provide a useful ‘aide memoire’ of potential issues to consider.

2. HMRC Enquiries

When it comes to HMRC commencing enquiries into the tax returns of self-employed individuals, it would not be surprising if cash businesses were seen by HMRC as something of a 'soft target'. The record keeping standards expected by many HMRC officers appears to be very high, and even the smallest discrepancy can result in proposed additions to turnover and/or disallowances of business expenses. However, a recent tax tribunal case, *Stephen Ho v CRC* [2010] UKFTT 387 (TC) TC00669 perhaps offers the self-employed (particularly potentially vulnerable cash traders) some comfort.

The case concerned Mr Ho, who is a taxi driver mainly working in and out of Heathrow Airport. HMRC enquired into Mr Ho's 2004 tax return. Following the completion of the enquiry, HMRC increased Mr Ho's self-employed profits for that year, and also raised discovery assessments for the tax years ended 5 April 2003, 2005, 2006 and 2007, resulting in additional liabilities for those years. Mr Ho Appealed.

Demonstrating turnover

HMRC contended that Mr Ho underestimated his takings and taxable profits. Mr Ho argued that his profits had not been understated, except for two specified days.

With regard to Mr Ho's records, each working day he would purchase fuel at the start of the day, and write the fares received on the back of the fuel receipt. He worked principally out of Heathrow Airport, which operates a system of 'cab tags' (these are purchased in batches, and must be handed over before the taxi driver can make his cab available for hire at the airport). A list of cab tags enabled Mr Ho to account for all but two working days. Both sides accepted that there was a small error in Mr Ho's records in respect of those days.

HMRC's case against Mr Ho was based around the expected number of trips out of Heathrow. No account was apparently taken of certain health problems suffered by Mr Ho. HMRC also relied on a cashflow test, based on business receipts and private cash expenditure. HMRC’s conclusions about Mr Ho's private expenditure were also based on assumptions.

The tribunal held that Mr Ho failed to declare income for two days due to the accidental loss of receipts, but that this was insufficient to amount to negligence under the discovery assessment provisions. The tribunal also rejected HMRC's contentions about Mr Ho's working pattern, and the conclusion of

HMRC's cashflow test (which the tribunal considered was 'fundamentally flawed'). Mr Ho's appeal against the HMRC amendment to his 2004 self assessment return and the discovery assessments for other years was therefore allowed.

Interestingly, the tribunal made a direction for costs against HMRC. The tribunal concluded that there had been 'unreasonable conduct' by HMRC, on the grounds that HMRC's arguments lacked sufficient evidential foundation, and that the cashflow test was flawed.

Record keeping

Mr Ho was perhaps fortunate that the taxi 'tagging' system at Heathrow Airport enabled him to verify his journeys to and from the airport, which in turn helped to substantiate his income. Unfortunately, many business owners are not so lucky. HMRC's guidance states: "In an enquiry case you will often be examining the possibility that the taxpayer has spent unrecorded cash" (EM3651). The importance of keeping full and accurate business records cannot be overstated, particularly for cash based traders.

In practice, it may prove difficult to satisfy HMRC that a taxpayer's business records are adequate. HMRC's Enquiry Manual gives the following advice to its officers (EM3683): "Even where the Return figure appears to be based on contemporaneous records, you should consider whether the nature of the trade or business is such that there are opportunities for unrecorded cash transactions. Even where the business is said to be mainly cheque based, transactions may be settled in cash."

The Enquiry Manual provides an interesting insight into HMRC's approach, such as in respect of personal and private expenditure (EM3650 to EM3685) and accounting records (EM2851 to EM2876).HMRC also cites (at EM3711) another case of a London cab driver (*Coy v Kime* 59 TC 447). In that case, the taxpayer used notebooks to record daily takings, which were not considered to be an accurate record and therefore enabled HMRC to assess further profits. Hopefully, the subsequent taxi driver case of Mr Ho should encourage HMRC officers to proceed with caution when dealing with enquiries into small and cash based businesses in the future.

3. More Gift Aid Problems

Gift Aid is a generous relief, particularly in the present tax climate. Its attraction to individuals is that the basic rate limit (£37,400) and the higher rate limit (£150,000) can be increased by qualifying Gift Aid donations (ITA 2007, ss 10(6), 414(2)). HMRC is seemingly aware of the generosity of the relief, and has previously sought to block schemes considered to exploit the relief (see HMRC Spotlight 9 (http://www.hmrc.gov.uk/avoidance/spotlights9.htm) dated 29 March 2010).

In addition, recent case law suggests that HMRC are very keen to ensure that Gift Aid donations by individuals satisfy the statutory conditions for the relief (ITA 2007, Pt 8, Ch 2). Two recent tax cases underline this point.

What is a 'gift'?

In *Winston Osborne v R&C* [2010] UKFTT 368 (TC) TC00650, the taxpayer appealed against a refusal by HMRC to accept Gift Aid claims in respect of an element of his subscriptions to a Masonic Lodge, which was paid through the Grand Lodge to the Masonic Grand Charity. The issue was whether the charitable element of the taxpayer's subscription to the lodge was a gift made by an individual to a charity, within the Gift Aid rules. The appellant argued that the Masonic Lodge subscription and the charitable donation were separate elements of a single payment.

However, the tribunal dismissed the taxpayer's appeal. It was noted that if the charitable element of the subscription had not been paid, the appellant's subscription to the Lodge would fall into arrears and his Lodge membership would be terminated. The entire subscription

(including charitable element) was compulsory. Thus there was no gift element as far as the charitable element was concerned, as the term 'gift' indicated a voluntary donation. There was no 'qualifying donation' for Gift Aid purposes.

Gift Aid and benefits

There is a rule in the Gift Aid provisions to prevent donations qualifying for relief if the donor (or a connected person) receives a benefit in consequence of making the donation, if the benefit exceeds certain limits (ITA 2007, ss 416(7), 418). This rule can sometimes cause unexpected problems for the taxpayer.

In *Harris (as trustee of the Harris Family Charitable Trust) v R&C* [2010] UKFTT 385 (TC) TC00667, the trustee of a charitable trust appealed against assessments to recover income tax repayments made in respect of Gift Aid donations. Mr Harris and his sister, Mrs Fine, had obtained higher rate tax relief on the grossed-up value of the gifts. Those gifts arose out of a deed of variation, in respect of their late mother's will. The residue of the mother's estate was left equally to Mr Harris and Mrs Fine. The deed of variation provided for legacies to the charitable trust. HMRC accepted the claim for IHT exemption on the charitable legacies. The payments were originally treated as donations made by Mr Harris and Mrs Fine under Gift Aid. HMRC subsequently enquired into the charity's income tax repayment claim.

The tribunal had to decide whether the inheritance tax (IHT) exemption resulting from the deed of variation was a 'benefit' which prevented the gift from qualifying for Gift Aid. For IHT purposes, the result of the deed of variation was that the redirected gift to charity was exempt. This question arose in *St Dunstan's v Major* [1997] STC (SCD) 212, which involved the sole residuary legatee of an estate executing a deed of variation if favour of a charity within IHTA 1984, s 142. The Special Commissioner held that the redirected legacy to charity was not a qualifying donation for income tax purposes, and that benefits were not confined to gifts provided by the charity itself. A benefit had arisen from the IHT saving as a consequence of making the gift by means of a deed of variation.

The tribunal held that there was a benefit because an IHT liability had been removed by the deed of variation, that would have attached to property over which Mr Harris and Mrs Fine had a right of disposition. They each received the benefit of the IHT exemption in their capacity as residuary beneficiaries, in consequence of making the gift to the charity, which exceeded the Gift Aid limit for allowable benefits. The tribunal reached the same conclusion as in the Dunstan case. The appeal was dismissed.

An alternative?

Interestingly, the tribunal touched upon a potential tax planning point in relation to charitable donations. Reference was made to the income tax relief for gifts of qualifying investments to charity (under what is now ITA 2007, ss 431-446). 'Qualifying investments' in this context includes listed securities and interests in UK land.

The tribunal noted that, unlike the position for cash donations under Gift Aid, the restrictions on relief for qualifying donations where benefits are received by the donor only operates as a reduction of the amount on which income tax relief can be obtained, and not as a blanket disqualification (ITA 2007, s 434). Qualifying donations of assets may therefore be a practical alternative if the donor is likely to receive significant benefits from the charity.

4. Domicile Status

Determining a person's domicile can be a difficult task. It very much depends on the facts, with circumstances varying in each case.

Many taxpayers and advisers would welcome the facility to agree a person's domicile status with HM Revenue &

Customs (HMRC) in advance of submitting tax returns. Unfortunately, HMRC seems increasingly reluctant to do so. For example, it was once possible to submit an application for an HMRC ruling on an individual's domicile status on form DOM1 ('Income and Chargeable Gains—Domicile') in advance of filing the tax return, on the basis that the matter of domicile was 'immediately relevant' to a UK tax liability. Unfortunately, HMRC subsequently announced (in HMRC Brief 17/09) the complete withdrawal of form DOM1.

Where an individual submitted form DOM1 (or P86) to HMRC and obtained an initial view about their domicile status, HMRC said that it would be 'unusual' for them to open an enquiry on domicile status in the few years after that, unless new information came to light or there had been a change in circumstances. Unfortunately, taxpayers must now self-assess their residence and domicile status, without the benefit of a DOM1 ruling from HMRC in advance.

Inheritance tax

For Inheritance Tax (IHT) purposes, HMRC also indicated in HMRC Brief 17/09 that if an IHT account was submitted by someone setting up the trust on the basis of not being domiciled in the UK, they would only open an enquiry into the return if the IHT at stake made it cost effective for them to do so. The initial IHT limit set was £10,000. However, this monetary threshold has now been withdrawn. HMRC indicate (in HMRC Brief 34/10) that they will consider opening an enquiry where domicile could be an issue, or making an IHT determination, where there is a significant risk of loss of UK tax.

But what actually constitutes 'signficant'? According to HMRC, it depends. They state: "HMRC does not consider it appropriate to state an amount of tax that would be considered significant, as the amount of tax at stake is only one factor." The costs of pursuing an enquiry and possible subsequent litigation will apparently also be taken into account. The issue seems to be one of resources, but unfortunately this effectively means that there is no level playing field; the wealthy individual claiming non-domicile status would appear to be more at risk of a domicile enquiry than someone with of modest means. In any event, it should be borne in mind that there is a special rule on domicile for IHT purposes. A person will be deemed domiciled in the UK in the following circumstances (IHT 1984, s 267):

- he was so domiciled within the last three years; or
- he was resident in the UK for 17 out of the last 20 years of assessment ending with the year of assessment in which the relevant time falls (this is sometimes referred to as the '17/20 rule').

Domicile enquiries

Taxpayers and advisers will invariably seek guidance from HMRC6 ('Residence, domicile and remittance basis) when attempting to establish domicile status, or at least HMRC's approach. However, the information, flowcharts and examples are unlikely to be of much assistance in any but the most straightforward of cases.

In the context of domicile status enquiries, HMRC warns in HMRC6 ('Residence, Domicile and the Remittance Basis'): "By its very nature, this sort of enquiry...will be an in-depth examination of your background, lifestyle and intentions over the course of your lifetime. An enquiry of this sort will extend to areas of your life, and that of your family, that you might not normally think are relevant to your UK tax affairs."

HMRC's Residence, Domicile and Remittance Basis (RDRB) Manual includes a section on enquiries into domicile status. The guidance states that it is unlikely that an adult's domicile will change unless "profound and extensive changes" are made to the individual's lifestyle, habits and intentions. The burden of proving a change of domicile rests with the party who asserts the change. HMRC

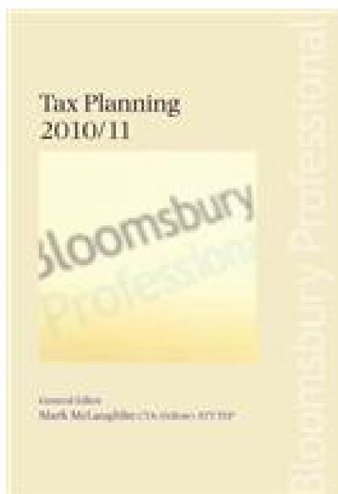
do not consider that an individual's country of residence is decisive, although it becomes stronger evidence of domicile the longer the period of residence.

The RDRB Manual provides an interesting insight in HMRC's approach in domicile enquiries. For example, it includes an extensive list of information and documents that HMRC could request during a domicile enquiry (RDRB23080). The overall impression given by the guidance is that domicile enquiries are likely to be detailed and lengthy in many cases.

However, some comfort can perhaps be derived from HMRC Brief 34/10, which states: "Where HMRC does open an Inheritance Tax enquiry...[it] may stop the enquiry at any stage if it considers the continuation of the enquiry is not cost-effective. The outcome of such an enquiry may be that HMRC does not consider it appropriate to make a determination of the Inheritance Tax."

The Government is considering a statutory test for determining an individual's residence status. However, domicile is a matter of general (not tax) law, so it seems that uncertainty about domicile status is likely to continue.

Publications for 2010/11



Tax Planning 2010/11

I am Editor and co-author of 'Tax Planning 2010-11', published by Bloomsbury Professional.

The chapters I have written or co-written deal with incorporation, company purchases of own shares, business property relief, and wills, variations and disclaimers.

Other chapters of the book include 'starting a business' by Rebecca Cave, 'disincorporating a business' by Partha Ray and 'tax planning for the non-resident and non-domiciled' by Robert Maas.

'Tax Planning 2010/11' is updated to include:

- Finance Act 2010, Finance (No. 2) Act 2010;
- Corporation Tax Act 2010;
- Taxation (International and Other Provisions) Act 2010;
- Recent case decisions and new HMRC practices;
- June 2010 budget announcements of relevant proposed future tax changes; and
- Commentary on the new CGT rate and changes to entrepreneurs' relief

For further information and to order a copy of Tax Planning 2010-11, visit: www.bloomsburyprofessional.com

Mark McLaughlin CTA (Fellow) ATT TEP

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