

PRACTICE UPDATE

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HOLIDAY OFFICE CLOSURES

The office will be closed for Christmas and New Year on 23 December 2011 and will reopen on 3 January 2012. **SEASON'S GREETINGS AND BEST WISHES FOR 2012!**

1. Penalties and costs

Taxpayers have recently been successful in a number of appeals before the tax tribunal on the grounds of 'reasonable excuse', mainly in respect of late filing penalties. One such case is highlighted below. In addition, the approach of HM Revenue and Customs (HMRC) in a case involving a discovery assessment was criticised by the tribunal, which awarded costs against HMRC. Perhaps a pattern is developing here – the taxpayer strikes back!

In *The Executors of David Atkins (deceased) v Revenue and Customs* [2011] UKFTT 468 (TC), HMRC had withdrawn a discovery assessment at a very late stage before an appeal against it was due to be heard. However, the appellants pursued an application for costs. The tribunal pointed out costs could only be awarded if HMRC had "acted unreasonably in bringing, defending or conducting the proceedings".

The deceased taxpayer had been a Lloyd's 'name'. Due to the way in which Lloyd's activity is treated for tax purposes, it can be some time after the enquiry window is closed before a tax return can be finalised for a particular year. HMRC practice was therefore to open enquiries into returns, in order to keep Lloyd's matters open. HMRC had guidelines for

executors of Lloyd's names to this effect, in connection with 'Special Reserve Fund' valuations and later adjustments to the tax return for the last period preceding death.

The deceased taxpayer's agent had sent HMRC a letter reminding them to open an enquiry. However, no enquiry was opened. HMRC subsequently sought to make a discovery assessment, as this was the only way of assessing tax in respect of the Lloyd's income following the closure of the enquiry window for the relevant tax return. Considerable work was undertaken by the taxpayer's agent in preparing for an appeal against the discovery assessment.

The tribunal pointed out that, for a discovery assessment to be made, the tax return must be wrong in some way, and considered that the return was made in accordance with correct practice, in conformity with HMRC guidelines, and was absolutely correct. The tribunal judge commented: "*The problem in this case results entirely from the way in which HMRC have themselves failed to act in accordance with their own guidelines in failing to open an enquiry into the relevant return.*"

Penalties and Costs

The tribunal concluded that HMRC had forced the appellants to prepare for an appeal that involved considerable costs and no deserved merit. The Judge said:

“HMRC have... been very unforthcoming to either the appellant or to me in admitting their fundamental errors”, and awarded the appellants their costs.

Excessive Penalty

HMRC's actions were also criticised in *Hok Ltd V Revenue and Customs* [2011] UKFTT 433 (TC). In that case, HMRC sent the appellant company a penalty notice for £400 on 27 September 2010, in respect of late PAYE return forms P35 and P14, which were due by 19 May 2010. The penalty was calculated at £100 per month for four months. A further penalty notice for £100 was issued on 21 October 2010, as the returns had been filed on 15 October 2010.

The company had been under the mistaken belief that the returns were not required because its only employee had ceased employment part way through the year. The company accepted that a penalty was due, but complained that if HMRC had notified the default sooner, it would have been remedied at a far earlier time, thus avoiding ongoing penalties. The company's appeal was therefore based on the penalties being excessive.

The tribunal considered that the company was entitled to rely upon the common law duty of a public body to act fairly in both its decision making process and the administration of its statutory powers. It stated: *“We are in no doubt that such a body does not act fairly where it deliberately desists from sending a penalty notice, for four months or more, knowing that the effect will be to impose a minimum penalty of £500 upon somebody whose sin may be no more than oversight or forgetfulness.”*

The tribunal noted that HMRC deliberately waits until four months have gone by and does not issue the first penalty notice until September in the year of default. Whilst appreciating HMRC's stance that it had no obligation to issue any reminder for outstanding returns, the tribunal had no doubt that *“any right thinking member of society”* would consider that to be unfair and falling very far below the standard of

fair dealing and conscionable conduct to be expected of an organ of the state. There was no logical reason whatsoever for HMRC to delay sending out a penalty notice for four months. The tribunal said that it is no function of the state to use the penalty system as a *“cash generating scheme”*.

The tribunal considered that *“it would be a very simple matter for HMRC to set its computer settings so that a default or penalty notice was sent out immediately after 19 May in any year, instead of some four months later.”* There was nothing fair or reasonable about setting a computer system so that it does not generate a penalty notice until the return was four months late, thereby ensuring a penalty of not less than £500. The tribunal held that HMRC had *“acted neither fairly nor in a good conscience”*, and that no penalty was chargeable over and above the £100 penalty for the first month.

Conclusion

Both cases should give some taxpayers some encouragement to challenge HMRC's behaviour and practices if they seem to be unreasonable. It will be interesting to see whether, following the *Hok* case, HMRC will change its practice about penalty notices for late returns and start issuing them sooner after the filing date.

2. Ownership tax issues

It is straightforward in most cases to establish an individual's income entitlement for tax purposes. However, there are exceptions. HM Revenue and Customs (HMRC) recently issued new guidance in its *Trusts Settlements and Estates* manual on the concepts of 'resulting trust' and 'constructive trust' for income tax purposes. These are 'implied trusts', which are created by operation of law, as opposed to 'express trusts' which a settlor normally creates expressly by trust deed.

Resulting trusts

A 'resulting trust' is a legal concept. It basically means that property reverts back to the settlor. HMRC guidance provides various examples of a resulting trust, one of which is reproduced below in the context of a joint saving account (see TSEM9620):

Example

"A contributes 100% of the funds in a saving account in the name of A and B. There is presumption of a resulting trust, whereby A holds 100% of the beneficial interest in the funds. A is taxable on all the income."

[Note – the example points to separate guidance in the case of property held jointly by married couples and civil partners (TSEM9800 onwards) which deals with the '50/50' rule and the 'form 17 rule' and the specific tax legislation for spouses and civil partners in ITA 2007, ss 836–837.]

It is presumed that the settlor had an intention that the property would revert back to him or her. However, HMRC accepts that this presumption can be rebutted, such as by the following:

- (a) *Gift or loan* – if there is evidence to that effect;
- (b) *Other factors* – if they show evidence that the 'contributor' did not intend to take an interest in the property;
- (c) *Express trust* – such trusts can include oral trusts;
- (d) *Presumption of advancement* – this mainly applies in the family context of purchases or contributions by (say) father for child or husband for wife (but not where a wife provides money for property for her husband) (Note – The presumption of advancement may be abolished from a date to be appointed – see Equality Act 2010, s 199).

The 'presumption' is that the husband/father etc intended the 'advancement' (i.e. the purchase or contribution) to be a gift.

HMRC considers that further principles relating to resulting trusts may apply for

income tax purposes in the context of land and buildings. Firstly, an agreement following the acquisition of property cannot give rise to a resulting trust, as it must be there from the outset. Secondly, establishing a resulting trust requires a direct contribution to the purchase price of the property at or from the date of purchase (e.g. cash, contribution to the deposit, mortgage payments).

Constructive trusts

HMRC's guidance acknowledges that a constructive trust is a legal concept, which can apply in a non-tax context (e.g. home ownership by unmarried couples, or where a shareholder receives an unlawful dividend and thus holds it as a 'constructive trustee' for the company. In a tax context, HMRC states that a constructive trust arises where "*...there is an alleged agreement or 'common intention' that the parties should share beneficial ownership of the property in some way that differs from the legal ownership or from the normal presumption of resulting trust, with the result that the income tax liability is not entirely on the legal owner.*" HMRC provides the following illustration.

Example

"For example, A has legal ownership of property, but claims that A and B have an agreement that the beneficial ownership is to be shared 50/50. Or A has provided all the funds, but claims there is an agreement that the property is to be shared between A and B."

In the case of land, a disposal cannot generally be effected except by a signed document. The same applies to a declaration of trust in respect of land. However, this requirement does not apply to constructive (or resulting or implied) trusts (Law of Property Act 1925, s 53(2)). HMRC will require taxpayers to establish that a constructive trust exists, by considering the following questions (TSEM9710):

- 1) Was there an agreement or "common intention" that the parties should share beneficial ownership of the property?

HMRC will require evidence that at the time of purchase there was an agreement or common intention that the beneficial interests should not follow the legal interest (e.g. Mr A is to be the legal owner, but beneficial ownership is to be 50:50 between Mr A and Mrs A). The agreement may be express or implied by conduct.

2) If so, did the parties act to their detriment (disadvantage) in reliance on that agreement or common intention or change his or her position? HMRC defines 'detriment' in this context as something which he or she could not reasonably be expected to have done unless they were to have an interest in the property, and considers that the detriment must be 'significant' (TSEM9730).

3) If so, what is the size of the beneficial interest to which the claimant is entitled? This will be a question of fact, but is not necessarily confined to looking at contributions towards the purchase price.

HMRC will require taxpayers who argue for a constructive trust to present their claim as if it was being presented to a court of law (TSEM9750).

Capital gains tax

Resulting and constructive trusts are also potentially relevant in a capital gains tax (CGT) context. For example, private residence relief is available to trustees on the disposal of a property which has been the only or main residence of a person entitled to occupy it under the terms of a settlement (TCGA 1992, s 225). HMRC's Capital Gains Manual contains further guidance on resulting and constructive trusts (at CG65415-CG65426).

HMRC considers that a claim for private residence relief under TCGA 1992, s 225 is most likely to depend on the taxpayer establishing that there is a "common intention constructive trust" (for cases in England and Wales), by reference to non-tax cases, *Oxley v Hiscock* ([2004] EWCA Civ 546) and *Stack v Dowden* [2007] UKHL 17. More recently, in *Kernott v Jones* [2011] UKSC 53, unmarried co-habitants bought a house in 1985, and jointly owned it, without making any

declaration as to how their beneficial interests should be apportioned. The relationship ended, and Mr Kernott moved out. Ms Jones had originally contributed £6,000 of the £30,000 purchase price, and the balance had been funded by an interest-only mortgage. Following the separation, Ms Jones continued to live in the property, and assumed sole responsibility for the mortgage and outgoings. Mr Kernott later demanded his half-share of the house. However, the County Court awarded Ms Jones 90% of the equity. Mr Kernott unsuccessfully appealed to the High Court. Subsequently, the Court of Appeal held that each party had a 50% beneficial interest in the property. However, the Supreme Court overturned that decision, stating that an initial presumption of joint tenancy in law and equity can be displaced if the parties changed their intentions, and that a court can deduce their common intention from their conduct.

The land registry form (TR1) includes a 'declaration of trust' box. If it has been completed, HMRC will treat it as an express trust, which will be binding on the parties who make the declaration. Whilst this does not prevent a claim by a third party that there is a constructive trust, HMRC indicates that this may be difficult to establish, and illustrated this point in the following example (CG65420):

"For example, a husband and wife buy a house and complete the TR1 showing that they own the property as tenants in common in equal shares. They allow their daughter to live in the house rent-free but she has to maintain the property and pay for the property insurance. When the house is sold the parents claim that they held it on constructive trust for the daughter. The fact that they declared they held the property on trust for themselves is good evidence that they did not intend to hold in on trust for anyone else. A constructive trust would have to arise later as a result of a fresh agreement or some further act of detriment by the third party such as a very substantial contribution to improvements. Such a later agreement would be exceptional."

Taxpayers wishing to claim private residence relief under TCGA 1992, s 225 on the basis of a constructive trust will probably need to convince HMRC that two conditions were satisfied. Firstly, that there was a common intention that both parties (i.e. the trustees as legal owners and the beneficiary) would have an interest in the property (i.e. by express agreement, or inferred from their conduct). Secondly, the beneficiary acted to his or her detriment on the basis of that common intention (such that it would be inequitable to deny that interest). In the context of CGT relief under s 225, HMRC points out (CG65422):

"When applied to TCGA92/S225 this means that the legal owners of the property will claim they held the property as trustees of a constructive trust under which a person occupies the property as a beneficiary of that trust. The legal owners will also be the settlors of the trust as they will have provided the property either by buying it so it can be occupied or by providing a property they already own. The terms of the trust will usually be that the beneficiary had a life interest in the property."

If an individual uses his or her own money to buy an asset (e.g. a property) in the name of someone else, HMRC considers that a bare trust should generally be regarded as existing in favour of the purchaser (CG34400). However, if the other person is the purchaser's wife or child, the purchaser will be presumed (in the absence of evidence to the contrary) to have made a gift to the wife or child.

In the recent case *Singh v HMRC* [2011] UKFTT 584 (TC), four properties were held to have been bought and sold by the taxpayer on trust for himself and one of his brothers equally. The First-tier tribunal in that case made the following distinction between resulting and constructive trusts:

"The Tribunal's view is that, under a resulting trust, the interest held under trust must have been created at the date of acquisition of the property and, in the case

of a constructive trust, prior to the property's disposal." The tribunal added:

"A distinction must be drawn between resulting and constructive trusts when calculating the parties' beneficial shares. A resulting trust only recognises the actual payments made. For a constructive trust there must be a finding of either an implied common intention resulting from a substantial contribution or an express common intention between the parties, of shared beneficial ownership in the property, plus an act of detrimental reliance on that intention by the party or parties not on the title. Only where such a common intention cannot be found can a resulting trust be inferred from financial contributions towards the acquisition of the property. If a common intention and thus a constructive trust is found, a court can ascertain the individual beneficial shares at its discretion."

Conclusion

Whereas an express trust generally operates according to a trust deed, resulting and constructive trusts apply by operation of the law. Of course, HMRC guidance does not carry the force of law, and its approach may be called into question. Indeed, in the *Singh* case, the tribunal commented: *"HMRC says that, 'whilst an agreement could initially be made orally, it must be followed up in writing prior to the disposal of the asset'. No case law authority for this particular proposition was offered by HMRC and it is not one with which the Tribunal would necessarily agree."*

However, an awareness of HMRC's approach to implied trusts will be useful if seeking to demonstrate that one exists. The common thread running through HMRC's income tax and CGT guidance is the importance of evidence where it is claimed that legal and beneficial ownership differs. Such evidence may include direct contributions to the purchase price, the payment of regular mortgage contributions, or possibly significant contributions by way of manual labour (CG65425). It may also be relevant whether (say) the legal owners of a

property have made it clear (e.g. to banks or mortgage lenders) that they own the property subject to an agreement that an occupier has an interest in it (CG65426). The onus of proof will be on the person who asserts that there is a difference between the legal and beneficial ownership to show how it differs.

3. Private residence relief

Married couples (and civil partners) benefit from favourable treatment for certain tax purposes. A common example is the 'no gain, no loss' capital gains tax (CGT) treatment for inter-spouse transfers (TCGA 1992, s 58). In addition, the inheritance tax spouse exemption is unlimited for transfers between UK domiciled spouses (although it is restricted to £55,000 if the transferee spouse is non-UK domiciled).

Living together

The principal private residence (PPR) rules for CGT purposes include a provision for married couples. It states that there can only be one sole or main residence for both spouses (or civil partners) so long as they live together (TCGA 1992, s 222(6)). In addition, any PPR election for their sole or main residence must be made by them both.

The meaning of 'living together' appears clear and unequivocal on the face of it, but this will not always be the case. The term shares the same meaning as for income tax purposes (TCGA 1992, s 288(3)). The income tax legislation states that spouses and civil partners are treated as living together unless they are separated under a court order, or by deed of separation, or are separated in circumstances where the separation is likely to be permanent (ITA 2007, s 1011).

In *Benford v CRC* [2011] UKFTT 457 (TC), the tribunal had to consider whether the taxpayer had separated from his wife for PPR purposes. The taxpayer had purchased a property in his sole name, and later sold it at a gain. He claimed CGT relief on the property on the basis

that it had been his principal private residence during a period of separation from his wife (it was common ground that she had never occupied the property). HMRC subsequently raised a CGT assessment under the 'discovery' rules in respect of the property disposal. The taxpayer appealed.

The onus of proof was on the taxpayer to establish on a balance of probabilities that the property was occupied as his residence during the period he owned it, and that during this time he was separated from his wife in such circumstances that the separation was likely to be permanent. The tribunal said that whether the taxpayer occupied the property was a question of fact. Having considered the evidence, the tribunal found that he did indeed occupy the property during his period of ownership.

However, the tribunal also noted an absence of "convincing documentary evidence" to show that the taxpayer lived in the property, a lack of furniture and appliances there and a very small amount of electricity used. The tribunal held that there was not sufficient assumption of permanence or degree or expectation of continuity to turn such occupation into residence.

In terms of whether Mr and Mrs Benford's separation was likely to be permanent, the tribunal concluded that the taxpayer had not discharged the burden of proof required to demonstrate that he was separated from his wife in such circumstances that the separation was likely to be permanent. It was therefore held that he should be treated as living with his wife for CGT purposes. As mentioned above, TCGA 1992, s 222(6) provides that there can only be one residence or main residence for a husband and wife living together. As Mrs Benford had never lived at the property bought by Mr Benford, the matrimonial home was considered to be the taxpayer's main residence. The taxpayer's appeal was dismissed.

Conclusion

This case emphasises the need for taxpayers to provide satisfactory evidence to support claims or assertions in enquiry cases. The burden of proof in tribunal cases is on a balance of probabilities.

The concept of 'living together' for tax purposes is not always straightforward, and can be counterintuitive. For example, if one spouse (or civil partner) is resident in the UK but the other is non-resident, they may still be treated as living together, assuming that they are not separated (*Gubay v Kington* [1984] 1 All ER 513, HL). Some care is therefore needed to ensure that a couple satisfies the statutory definition of living together in the relevant tax year.

4. Loan relationships

The loan relationships provisions for companies have been around since 1996, and it is fair to say that the legislation overall is complex. However, it is not normally difficult to identify a loan relationship for these purposes, although a recent case indicates that even this task may not be without its problems.

The loan relationship legislation in FA 1996 was rewritten and is now contained in CTA 2009. It states that a company has a 'loan relationship' for corporation tax purposes if it is either a debtor or a creditor in respect of a money debt, and the debt arises from a transaction for the lending of money (CTA 2009, s 302). HMRC guidance points out that not all money debts arise from the lending of money, such as trade debts (CFM31010). The same applies to directors' loan accounts consisting only of undrawn or overdrawn remuneration etc.

In the context of inter-company accounts, HMRC states that balances on such accounts may arise from the lending of money where one group member has borrowed from another (CFM31040). Money debts not arising from the lending of money are brought into the loan relationship regime (as 'relevant non-lending relationships'), by treating them as such (CTA 2009, Pt 6).

The term 'transaction for the lending of money' seems straightforward enough on the face of it. However, in *MJP Media Services Ltd v CRC* [2011] UKUT 100 (TCC), the taxpayer company (MJP) was a wholly-owned subsidiary of company C. Company C in turn was a wholly-owned subsidiary of company A. A series of inter-company transactions took place between MJP and company A. A signed agreement stated that MJP had loaned a sum of money to company A, and provided for interest to be charged. A deed of waiver was subsequently signed, in which MJP agreed to waive most of the outstanding sum. MJP claimed a deduction in its corporation tax computation in respect of the waived amount. HM Revenue and Customs (HMRC) disallowed the deduction claimed in respect of the loan relationship debit. MJP appealed.

Lending of money

The First-tier tribunal ([2010] UKPTT 298 (TC)) had to consider whether the inter-company debt arose from 'transactions for the lending of money' and was thus within the definition of loan relationship. The tribunal decided against the taxpayer company, which subsequently appealed. The Upper Tribunal noted that the First-tier tribunal made the point that MJP had only disclosed four bank statements, which showed only a few of the relevant transactions. The witnesses had given "unsatisfactory explanations" for the failure to produce bank statements for the other transactions, and did not have first-hand knowledge of the transactions.

Counsel for MJP defended the company's inability to produce the necessary bank statements (notwithstanding the requirement to retain them for six years for VAT purposes), the witnesses' lack of first-hand knowledge of the relevant transactions, the accounting documents (which the First-tier tribunal had regarded as incomplete evidence), and an inability to explain certain matters. However, the Upper Tribunal rejected those arguments.

To prevail on the appeal, MJP needed to succeed in its arguments on all (four)

transactions. The Upper Tribunal considered two of them, and agreed with the First-tier tribunal that the first transaction was not, on the balance of probabilities, a cash payment. The tribunal was not obliged to explain the transaction and why the same sum subsequently turned up in the books of company A. With regard to the second transaction, MJP had argued that company A had repaid £6.1 million to company C, that company C had repaid the same sum to MJP, and that MJP had paid company A the same sum. However, it was unable to explain why the transactions took place or how the transfers had been made, or show that cash payments had been made as opposed to transfers by book entry. It was held that the First-tier tribunal had been entitled to conclude that MJP had taken over company A's debt to company C, in exchange for cancelling company C's own debt, and that the transaction had been by book entry.

The Upper Tribunal also dismissed MJP's argument that even if payments were made by MJP to third parties on behalf of company A, that was sufficient to amount to "transactions for the lending of money". The company's appeal was dismissed.

The first hurdle

In practice, it is perhaps understandable to focus on how a loan relationship should be treated for tax purposes, particularly in view of the complex legislation in this area. However, the MJP case is a reminder of the importance of ensuring that a transaction falls within the statutory definition of a loan relationship to begin with.

The case is perhaps unusual, in the sense that the taxpayer company could not produce bank statements for all relevant transactions, or provide other satisfactory evidence or explanations to support its arguments. However, it does emphasise the general need to retain records and documentary evidence of transactions, not least because of a statutory requirement to do so in many cases (e.g. TMA 1970, s 12B for individuals, or FA 1998, Sch 18, para 21 for companies), and also where

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such evidence is important to the taxpayer's claims or arguments.

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3. Ray & McLaughlin's Practical IHT Planning (Bloomsbury Professional)



Practical Inheritance Tax Planning, 10th edition (Mark McLaughlin, Geoffrey Schindler, Paul Davies and Ralph Ray)

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