

PRACTICE UPDATE

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1. Income Shifting – A Tax Adviser's Nightmare!

THE PRESIDENT of the Chartered Institute of Taxation, Rob Ellerby, recently protested to the Government in a strongly-worded letter that the proposed new rules on 'income shifting' were not "fit for purpose". Upon reviewing the draft legislation and HMRC's guidance notes, in my opinion it is difficult to reach an alternative view.

The proposals swiftly followed HMRC's defeat in the House of Lords in the 'Arctic Systems' case. The draft legislation is relatively short for such wide-ranging proposals – six sections in total. Such brevity could be seen as a good thing, but in fact it is not. The legislation is open to interpretation, and HMRC have taken the opportunity to produce a consultation document of around 40 pages with draft guidance on their interpretation of how the rules work. There is a worrying trend developing of short but widely-drafted legislation supported by lengthy HMRC guidance (the targeted anti-avoidance rule on capital losses and guidance arguably being an even more disturbing instance). The guidance does not carry the force of law, but HMRC will no doubt seek to apply it in practice as though it represents the law.

When the rules will apply

The proposed rules will apply if four conditions (A to D) are satisfied. Note that all four conditions must be satisfied or otherwise the income shifting rules cannot apply. These can conditions can broadly be summarised as follows:

Condition A - An individual (1) is a party to, or has power over, 'relevant arrangements' (see below);

Condition B – Individual 1 forgoes income (see below), which becomes income of another individual (2) for the relevant tax year;

Condition C – individual 1 has power over the amount shifted; and

Condition D – the shifted income comprises company distributions or partnership profits.

Individual 1 'forgoes income' if he or she would be entitled to the income, or might reasonably be expected to receive the income based on the work that they have done. 'Relevant arrangements' are generally defined in terms of being non-commercial, where it would be "reasonable" to conclude that saving tax was a main purpose. This is an area where potential problems are sure to arise. For example, what is 'reasonable'?

What is 'Arm's length'?

There are rules to determine if arrangements are 'commercial' or not, whereby three conditions must be satisfied. The first condition is a business purpose test, and the second relates to companies with investment business. The third condition will cause problems. It provides that the arrangements must be on 'arm's length' terms. But what is 'arm's length'? Such questions call for judgement and opinion, which are likely to result in uncertainty and possible disagreement with HMRC. If caught by the new rules, the shifted income will effectively be treated as that of Individual 1.

Practical points

The following are some key practical points to come out of the proposed legislation and guidance:

- ◆ Husbands, wives and civil partners are potentially 'caught'. However, the rules have wider scope. Owner-managed businesses run by other family and close friends may also be affected.
- ◆ The rules apply to shifted dividends or profits of 2008/09 and later years. However, they are likely to impact upon undistributed income of earlier years.
- ◆ The rules will only apply if the income shifting produces a tax saving. So if (say) husband and wife are already higher rate taxpayers, the rules cannot apply to any income shifted between them.
- ◆ Salaries are not subject to the income shifting rules. The new provisions only apply if company distributions or partnership profits are shifted.

The consultation period for the income shifting rules ends on 28 February 2008. Firms who feel that the proposals are unworkable, unrealistic or otherwise, should make their thoughts known by that date. It seems unlikely that the Government will do a 'u-turn' on the proposals, but the absence of a response may lead to the conclusion that advisers are in agreement with the income shifting rules – are you among them? In addition, advisers of potentially affected clients should be thinking now about how they will need to act in their clients' best interests under the new rules. In other words, hope for the best – but prepare for the worst! Please contact me if you wish to discuss the income shifting rules, or have any queries on their possible application.

2. Easily Wound Up!

THE CURRENTLY POPULAR method of ending an owner-managed company involves approaching for approval to apply Extra Statutory Concession C16. This concession applies when a company is to be dissolved under Companies Act 1985, ss 652 or 652A (or comparable provisions). However, Concession C16 is incompatible with company law, as it is unlawful to return capital

to shareholders otherwise than on a winding up. Concession C16 merely provides for distributions to shareholders to be treated as though they were made under a formal winding up.

However, from 1 October 2009, this dilemma will be resolved following changes introduced in Companies Act 2006. A private company will be able to reduce its share capital by special resolution, supported by a solvency statement, where certain conditions are satisfied.

At present, company distributions to shareholders during a winding up, whether under Concession C16 or in a formal liquidation, are treated as full or part disposals for capital gains tax purposes (or for corporation tax on chargeable gains). The same tax treatment will apply to capital repayments under the Companies Act 2006 rules.

My article 'ESC C16 and CA 2006' (Busy Practitioner, December 2007) looks at some of the conditions for a share capital reduction under the new rules, and also comments on the effects of winding up companies under the 'transactions in securities' anti-avoidance rules, for 'phoenix companies' and also in respect of the 'Bona Vacantia' rules in England and Wales.

For a free copy of 'ESC C16 and CA 2006' please fax back this page of the Newsletter.

If your practice has settlor-interested trusts and you require any assistance regarding their tax treatment, please do not hesitate to contact me.

3. Are you certain?

IT IS OFTEN COMFORTING to know the tax implications in advance of a transaction taking place, particularly if (as is often the case) the tax law is unclear or unhelpful.

One recent development which has perhaps not received the attention it deserves is that HMRC launched a clearances pilot on 2 January 2008, which runs until 31 March 2008. Apart from certain large businesses, the pilot service is only presently available to unincorporated businesses and companies whose tax affairs are dealt with by Local Compliance Offices within the North West and Midlands areas. However, HMRC plan to

operate an extended clearances service fully from April 2008.

Wider scope

HMRC will give their view of the tax consequences of transactions that are “commercially significant” to the business. Previously, business clearance applications were required to comply with the terms of HMRC’s Code of Practice 10 (COP10) (‘Information and Advice’). One of the problems with COP10 was that HMRC would normally only give tax clearances relating to direct tax legislation over the last four Finance Acts. Two exceptions to this general rule applied in respect of the Substantial Shareholders Exemption and Stamp Duty Land Tax. The clearances pilot removes this four year restriction completely. HMRC will normally aim to respond to clearance applications within 28 days.

In addition to recent tax legislation, HMRC will generally provide clearances where there is material uncertainty on legislation older than the last four Finance Acts, on issues of “commercial significance” to the business, in terms of the scale of the business and the impact on it. Clearance applications can be pre or post-transaction. The statutory clearance procedures (e.g. for ‘transactions in securities’ in ITA 2007, s 701) remain unchanged.

Firms wishing to take advantage of the clearances pilot on behalf of their business clients should refer to the draft business clearance guidance on HMRC’s website (<http://www.hmrc.gov.uk/cap/links-dec07.htm>) for further details, which replaces the guidance in COP10 (for businesses, but not for individuals) and its VAT equivalent, VAT notice 700/6.

Company trading status

The pilot of the extended clearance procedure is potentially very useful in practice. For example, we recently dealt with a case in which a shareholder wished to gift shares to a family member, and claim gifts holdover relief (TCGA 1992, s 165). However, there was uncertainty over whether the company was a qualifying trading company for gift relief purposes, due to the level of investments. HMRC confirmed that they would be willing to

consider the company’s status for gift relief (and taper relief) purposes, if it could be demonstrated that the issue was of material significance to the business. As the client wished to pass a controlling interest in the company down a generation to new management, the issue is very important to the business, and we would expect HMRC to give their view on the trading status of the company when the clearance application is submitted. Of course, whether the extended clearance procedure will apply to such matters after the pilot has ended remains to be seen.

Clearance applications must be drafted carefully to ensure that they are complete and correct, as otherwise they cannot be relief upon. Please do not hesitate to contact me if you wish to make a clearance application and need any assistance.

4. IHT Planning – Simplicity!

THE PRE-BUDGET REPORT (PBR) 2007 announcement on the proposed transfer of unused IHT nil rate bands (NRBs) between spouses (or civil partners) came as a shock to many practitioners (me included!). The proposed transferable amount is fixed as a percentage of up to 100% of the NRB not previously used.

It has long been common to draw wills that leave a NRB discretionary trust in favour of the surviving spouse and immediate family so as to use the NRB of the first spouse to die, because under the ‘old’ rules that band was otherwise lost, with an effective tax loss (at 2007/08 rates) of up to £120,000. However, couples who made simple wills leaving everything to each other (perhaps with remainder to children on the second death) may now be in as good a position as those who took the trouble to obtain tax advice and who used the NRB trust route.

Practical issues

The following are some practical issues arising from the proposed legislation:

- ◆ NRB trusts may still be useful in certain circumstances (some of which are not IHT related), such as where future care costs are a concern, or for asset protection

purposes (e.g. in the event of financial or marriage failure). In addition, NRB trusts may be attractive if the value of an asset is likely to increase faster than increases in the NRB, or if the asset qualifies for BPR or APR at 100%.

- ◆ In addition to reducing IHT on the survivor's free estate, the ability to transfer the unused NRB on the first death has the potential to reduce the IHT liability on any gifts with reservation upon death, or in respect of qualifying (e.g. pre-22 March 2006) interest in possession property, or any additional tax on a chargeable lifetime transfer or IHT on a failed PET.
- ◆ Surviving spouses (or civil partners) who try to utilise an additional NRB on a chargeable lifetime transfer (e.g. to a discretionary trust) are faced with an IHT liability. However, on the survivor's death within seven years an extra NRB may then be available, albeit that there would be no refund of any lifetime IHT paid.
- ◆ The surviving spouse or civil partner (and their personal representatives) must keep and maintain records in respect of the first spouse or civil partner to die and their estate. Form IHT216 ('Claim to transfer unused Inheritance Tax nil rate band') includes a list of documents to be sent with the claim form.
- ◆ Problems may arise if HMRC did not formally agree asset valuations on the first death. HMRC do not generally check claims for 100% business or agricultural property relief where there is no immediate IHT liability (e.g. if personal representatives claim relief and no IHT liability would otherwise arise on the first death). However, this issue will now be relevant in determining the unused NRB available to the surviving spouse or civil partner. This may result in HMRC testing the earlier availability of BPR/APR upon the second death.
- ◆ If husband and wife are both still alive and have made NRB discretionary will trusts, what should they do? They could consider making new wills (although codicils to their existing wills may well be sufficient to dispense with the NRB legacy). Alternatively, there is scope (under IHTA

1984, s 144) for the trustees of a discretionary trust to appoint funds or assets to beneficiaries within two years of the death (but to avoid the difficulty suffered in *Frankland v IRC*, the trustees should not normally take any action until three months have elapsed from the date of death). A distribution from the discretionary trust should then take effect as if it was a gift under the terms of the will and not a distribution from the discretionary will trust. Therefore, there may be no need to change the will.

What now?

The proposed changes are not yet law. They could conceivably be amended, or even withdrawn. However, it was announced that they could be applied for second deaths from 9 October 2007, irrespective of when the first spouse died, so how should firms advise their clients in the meantime? The proposals were generally well received by taxpayers and practitioners, so it seems unlikely that any amendments will be made, at least not detrimental ones. However, it would be advisable to make clear to any clients who are considering acting on the basis of the proposed changes in advance of Finance Act 2008 that the final provisions may be different.

Please contact me if you need any assistance on IHT planning issues. In addition, my book '**Ray & McLaughlin's Practical IHT Planning**' (Tottel Publishing) covers IHT planning between spouses (and civil partners) in detail. The latest edition of the book also includes a supplement on transferable NRBs.

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