

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 Closure – Please note that the office will be closed from Thursday 6 August to Monday 24 August inclusive for the summer break.

1. What is 'Careless'?

The new penalty regime for inaccuracies in tax returns etc has arguably increased the stakes and made it even more important that all possible steps are taken to ensure tax returns are complete and correct. Incorrect tax returns resulting from careless (previously negligent) behaviour are subject to penalties under the new regime. But what is 'careless'?

In a recent case, *Cairns v Revenue & Customs* [2009] UKFTT 00008 (TC), HMRC tried to impose a penalty on Mr Cairns, a solicitor acting as personal representative for a deceased person's estate. Mr Cairns submitted an IHT return to HMRC following the deceased's death in October 2004, which included a value of £400,000 for the deceased's residence. This was based on a valuation by chartered surveyors in January 2004, which had been heavily qualified due to the poor state of the property. The District Valuer subsequently valued the property at £600,000 as at the date of death, which was also the amount for which the property was sold.

Incorrect and negligent?

The Special Commissioner was asked to consider whether Mr Cairns submitted an incorrect IHT account; and whether he acted negligently. The Special Commissioner held that "...the mere failure to obtain another valuation when it has not been established that a second

valuation would have led to a different figure being inserted in the statutory form does not constitute negligent delivery of an incorrect account." He added: "On the evidence before me, even if it were concluded that an incorrect account was delivered or furnished, it is simply not possible to conclude that it was negligently delivered or furnished except in one minor respect."

'Minor and technical' error

The minor matter referred to related to the fact that the valuation obtained had been heavily qualified, and was a provisional estimate. Mr Cairns had not disclosed this in the IHT account. The omission to do so was a careless error. However, the Commissioner added that "...it was minor, technical and of no consequence whatsoever." He concluded that there had been a "narrow, technical failure..." The account was incorrect. The sum of £400,000 should have been described as a provisional estimate. Whilst that failure was negligent, it was held to be a "failure of the merest technicality". The summons against Mr Cairns was dismissed. The Commissioner added that even if he had been wrong to dismiss it, he would have reduced the penalty to a nominal amount, or recommended that it be so reduced.

Whilst this case is potentially helpful in terms of identifying the circumstances in which penalties can be imposed for an incorrect return, there are a few points worth noting. The first point is disclosure.

The Commissioner said it would have been prudent for Mr Cairns to describe the value attributed to the deceased's property as a provisional estimate. As mentioned, this was careless in the Special Commissioner's view. Secondly, HMRC produced no valuation evidence in this case, such as an independent valuation of the property as at the date of the deceased's death. The onus was on HMRC to prove negligence on the balance of probabilities, and it probably did not help their case that no valuation evidence was submitted. Thirdly, the Special Commissioner concluded that negligent conduct amounts to more than just being wrong, or taking a different view from HMRC.

The conclusion to be drawn from this case would seem to be that under-valuations of assets will not always be negligent, and may not necessarily be careless, but that there must be full disclosure in the return.

2. Wills and 'Commorientes'

The rule regarding commorientes is concerned with determining survivorship where two or more people have died. The legislation is in the Law of Property Act 1925, s 184. It broadly states that where two or more people have died and it is unclear if one of them has survived the other, the law presumes that they died in the order of seniority, i.e. the younger person is deemed to have survived the elder (nb this section only applies to deaths in England and Wales). For IHT purposes, the potential effect of the commorientes rule could be double (or multiple) IHT charges on such deaths, albeit subject to quick succession relief for chargeable transfers (IHTA 1984, s 141). The IHT legislation therefore includes the following provision (IHTA 1984, s 4(2)):

"...where it cannot be known which of two or more persons who have died survived the other or others they shall be assumed to have died at the same instant."

Interesting results

The interaction of general law and tax law can have interesting results for husbands and wives with wills leaving their estates to each other. For IHT purposes, if it cannot be known which of the two survived the other, they are assumed to have died at the same instant. Therefore the older spouse's estate does not increase the estate of the younger spouse (IHTA 1984, ss 4(2), 54(4)). The effect of these provisions and the commorientes rule in LPA 1925, s 184 can result in the estate of the elder spouse or civil partner escaping IHT on both deaths. HMRC provide an example in the Inheritance Tax Manual:

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM12197.htm>

In addition, IHTA 1984, s 92 ('Survivorship clauses') addresses the potential problem of double (or multiple) IHT charges on successive deaths. It applies to deaths which are not simultaneous but follow within a short time period. This rule broadly provides that if (under the terms of a will or otherwise) property is held for a person on condition that he survives another for a specified period of not more than 6 months, and another beneficiary becomes entitled to the property because the original beneficiary did not satisfy the survivorship condition, the IHT position is the same as if that other beneficiary had taken the property from the outset.

Many wills for married couples or civil partnerships contain survivorship clauses, which are typically for 30 days or 3 months. There is no hard and fast rule to say whether survivorship clauses should be included in wills. However, as a general rule the facility to transfer IHT nil rate bands between spouses means that survivorship clauses are perhaps less important than before, particularly if the husband and wife each have assets that would utilise their nil rate bands.

The introduction of the transferable nil rate band in Finance Act 2008 has potentially improved the IHT position even further in commorientes circumstances. HMRC

3. Equitable liability

have confirmed in the IHT manual that because the nil rate band of the elder spouse is effectively unused, the younger spouse's estate can potentially benefit from it, assuming of course that it hasn't been used up by lifetime transfers.

Example

John and Susan are married and live in Cheshire. John is 10 years Susan's elder. Their estates are worth £600,000 each. They have made no lifetime gifts. They die simultaneously in an accident on 30 September 2009. Their Wills do not include a survivorship clause, and they leave their assets to each other on the first death, and otherwise to their adult children.

Applying the rule in the Law of Property Act 1925, s 184, John is deemed to have died first, so his estate would pass to Susan. However, for IHT purposes, the rule in IHTA 1984, s 4(2) means that John and Susan are assumed to have died in the same instant. HMRC's approach is to treat John's estate as being subject to the spouse exemption, but Susan's estate is treated as excluding John's estate. The result is that John's estate of £600,000 escapes IHT on both deaths, and passes to their children. Only Susan's estate of £600,000 is subject to IHT. However, in addition to Susan's own nil rate band of £325,000 being available, John's unused nil rate band of £325,000 is also available upon the making of a claim by Susan's Personal Representatives. The overall result is therefore that no IHT is payable on John or Susan's estates, and that assets worth £1.2 million in total pass to their adult children.

In cases where there is a survivorship clause in the wills of husband and wife (or civil partners), it may be worth considering the inclusion of a condition excluding the operation of the survivorship clause in 'commorientes' circumstances (i.e. on simultaneous deaths) in the will of the elder spouse or civil partner. This is a point to consider when, for example, carrying out an IHT review for clients who are either married or civil partners.

There has been increasing publicity and protest to HMRC's proposed withdrawal of the non-statutory practice known as 'equitable liability' from April 2010.

Equitable liability provides a potential solution if finalised tax liabilities prove to be too high. HMRC originally stated in Tax Bulletin 18 (August 1995):

"...where the taxpayer has exhausted all other possible remedies, the Inland Revenue may, depending on the circumstances of the particular case, be prepared not to pursue its legal right to recovery for the full amount where it would be unconscionable to insist on collecting the full amount of tax assessed and legally due."

However, HMRC announced on 22 May 2009 that the equitable liability 'concession' would be withdrawn from 1 April 2010. Only in 'exceptional cases' where taxpayers have a 'reasonable excuse' will HMRC accept late information and adjust taxpayers' liabilities. This will presumably be the case regardless of how probable it may be that a taxpayer's estimated liability is excessive.

Professional bodies and others including TaxAid and the Low Incomes Tax Reform Group have been making representations to HMRC about the potential difficulties and unfairness that will be caused by the withdrawal of equitable liability. Tax Barrister Keith Gordon has also started a petition opposing its withdrawal.

Join the campaign

There can surely be no justification for taxpayers having to pay more tax than would otherwise be actually due, regardless of the actions or inactions of the taxpayer. Firms can help to oppose the withdrawal of equitable liability in following ways:

1) Let me know of any situations in which your firm has used Equitable Liability to good effect.

2) Sign up to Keith Gordon's e-petition:
<http://petitions.number10.gov.uk/BeFairHMRC/>

There is a small window of opportunity between now and 1 April 2010 for firms to review the tax affairs of clients who are or may be affected if HMRC goes ahead with its planned withdrawal of the concession.

4. IHT and 'normal expenditure'

Many advisers, and some taxpayers, are aware of the Inheritance Tax (IHT) exemption for 'normal expenditure out of income' (IHTA 1984, s 21). Yet anecdotal evidence suggests that the exemption is not being fully utilised. Whilst most forms of tax relief or exemption have an upper limit (e.g. the income tax personal allowance or the annual CGT exemption), the IHT exemption for 'normal expenditure out of income' is not subject to an upper limit, so is effectively only restricted by an individual's personal circumstances.

A gift will benefit from the normal exemption in IHTA 1984, s 21 broadly if, or to the extent that, it complies with certain conditions:

- the gift was part of the normal expenditure of the transferor, and
- that (taking one year with another) it was made out of his income, and
- that, after allowing for all transfers of value forming part of his normal expenditure, the transferor was left with sufficient income to maintain his usual standard of living.

Whether each of these three tests is satisfied needs to be considered separately, and will depend on the specific facts of the case.

Example

Fred, aged 78, has net income after tax of £50,000, consisting of pensions and investment income. He leads a modest lifestyle, and has been able to save a regular sum of £2,000 per month. Fred makes regular monthly gifts of £750 per month each to his son and daughter. HMRC accepts that the gifts were part of

Fred's normal income. The available exemption means that he can still make use of his annual IHT exemption of £3,000 per annum.

The exemption is clearly very useful and valuable, and it is therefore unsurprising that HMRC will often check claims for the exemption. The following steps may be helpful when considering a claim:

- Record the gift – whilst financial records such as bank statements may show the gift, a simple, signed 'Gift Memorandum' or letter to the intended recipient is preferable, to confirm that the gift (and any similar gifts made) will leave the donor with sufficient income to maintain his or her usual living standards.
- Income and expenditure – It may be necessary to demonstrate to HMRC that the normal expenditure out of income conditions are satisfied. Donors may find HMRC's Schedule IHT403 (page 6 – 'Gifts made as part of normal expenditure out of income') useful on an ongoing basis to record income, expenditure and surplus income each year. This Schedule is available from HMRC's website: <http://www.hmrc.gov.uk/inheritancetax/ih403.pdf>
- Be aware of HMRC's internal guidance on the exemption, which is also available on HMRC's website (at IHTM14321 and subsequent paragraphs): <http://www.hmrc.gov.uk/manuals/ihmanual/IHTM14231.htm>

Mark McLaughlin CTA (Fellow) ATT TEP

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