

# PRACTICE UPDATE

March / April 2009

**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](http://www.taxationweb.co.uk)  
E: [tax@markmclaughlin.co.uk](mailto:tax@markmclaughlin.co.uk) W: [www.markmclaughlin.co.uk](http://www.markmclaughlin.co.uk)

Mark McLaughlin Associates Ltd – Reg. in England No 6127272

## IN THIS ISSUE:

1. **Rental income 'businesses'** – When jointly owned property can constitute a business.
2. **Interest relief for joint loans** – How joint loans can affect the amount of interest relief available.
3. **Concession C16: HMRC not keen?** – Will ESC C16 look very different when it becomes law?
4. **Let's be 'reasonable'!** – What does 'reasonable care' mean in terms of preventing a penalty?

### 1. Rental income 'businesses'

The current recession is affecting virtually everyone, including property investors. Many buy-to-let investors are finding it increasingly difficult to find tenants, and some are making significant losses.

Properties owned by a property investor generally constitute a single rental income 'business', and there is normally little difficulty in setting off a loss from renting one property against a profit from another. However, what is the position for the property investor who owns some properties in his/her sole name, but only has a joint interest in others? Do the different property interests constitute a single rental income business, so as to allow effective relief for losses?

HMRC's approach is that rental business activities are treated as a single business if carried on by the same person in the same legal capacity. For example, an individual could own investment property in his own right, and be the trustee of a trust in receipt of rental income. These would be treated as separate rental businesses.

#### Jointly owned property

What about jointly owned property? HMRC's view seems to be that the taxpayer's share from jointly owned property will usually be included as part of their personal rental business profits or losses. However, if the letting is carried on as a partnership, the taxpayer's share of the rental profit or loss from the property

rental partnership must be kept separate (e.g. a share of partnership losses cannot be deducted from personal rental business profits).

A potential difficulty is in establishing where a partnership exists. There is case law (HMRC often cite an old case, *American Leaf Blending*) to support the view that letting property can constitute a business. However, it may be difficult in practice to distinguish between a business and an investment. HMRC's guidance states the following (PIM1030):

"Most cases of jointly owned property will fall short of the degree of business organisation needed to constitute a partnership. To accept that a partnership exists you would have to be satisfied that there is a similar degree of business organisation as in an ordinary commercial business. This means more than treating rental income as derived from a business of letting property - it must be a business apart from that."

#### Spouses or Civil Partners

The tax position is different for property owned jointly by husband and wife (or civil partners) who live together. The general rule is that they are treated as entitled to property income in equal shares. However, there are six exceptions to this general rule for income tax purposes (in ITA 2007, ss 836, 837). One of these is that the income is from a partnership. Another exception is that the income is earned income, such as from furnished holiday lettings. A further exception is

where the spouses are beneficially entitled to the property income in unequal shares in accordance with their unequal beneficial ownership of the property, and make a joint declaration to be taxed on that basis.

HMRC's view of partnerships being a separate legal entity appears to contradict a general principal of English law, that a partnership has no separate legal identity from its owners (although the position is different with LLPs, and also under Scots law). It is possible that their approach may be tested in the Courts one day. In the meantime, taxpayers and their advisers need to be aware of HMRC's view - unless they are the ones wishing to challenge it!

## 2. Interest relief – joint loans

It is relatively common for married couples (or civil partners) to borrow funds in joint names (assuming of course that they can still find a bank that is willing to lend them money!). Tax relief may be available for the loan interest paid if the loan is for a qualifying purpose (eg to buy an interest in a close company, or to invest in a partnership), and if certain conditions are satisfied.

However, what is the position if husband and wife take out a joint loan, but only one spouse uses the whole loan for a qualifying purpose?

HMRC's view, perhaps rather generously, seems to be that the spouse using the loan for a qualifying purpose is entitled to full relief for the interest paid, even if the interest is paid out of a joint account. The example given in HMRC's Savings and Investment Manual is as follows (SAIM 10040):

### Example

"Mr and Mrs A took out a loan in joint names for £100,000 that was invested by Mr A in purchasing shares in a qualifying company. The interest paid on this loan in the tax year 07/08 totalled £10,000 and

was paid from a bank account held jointly in the names of Mr and Mrs A."

"Mr A would be able to claim relief for the full amount of interest paid in 07/08 of £10,000."

### Not so generous

However, the available relief is rather less generous if one spouse takes out the loan, which is then used by both husband and wife to invest the proceeds for what would otherwise be a qualifying purpose. In those circumstances, HMRC's view is that income tax relief would only be available to the spouse who took out the loan, and only in proportion to the amount of qualifying investment by the spouse who took out the loan (SAIM10030). The reason given for this restriction in relief is that:

"...the loan has to be used by the same individual to whom the loan was made. Under these circumstances, the amount invested by the spouse who did not receive the loan has not been used to make a qualifying investment by the spouse who received the loan. That amount has been used to enable someone else to make an investment."

The moral is to ensure that business loans are structured in the correct way to ensure that tax relief is maximised wherever possible. Whilst the reasons given by HMRC for the relief restriction seem logical, it is difficult (for me at least!) to understand why full relief is available to one of the spouses in the above example, despite half the loan arguably not being attributable to the 'qualifying' spouse, and presumably half of the loan interest being paid by the 'non-qualifying' spouse from their share of capital in the joint bank account. Still, if HMRC wish to be generous in giving full tax relief, it would be churlish to refuse!

## 3. ESC C16: HMRC not keen?

As indicated in my article 'Don't Wind Me Up!' in Taxation on 5 February 2009

(available at the Mark McLaughlin Associates website [www.markmclaughlin.co.uk](http://www.markmclaughlin.co.uk)) HMRC are replacing a number of Extra Statutory Concessions (ESCs), by making them law instead. One of these is ESC C16 ('Dissolution of companies under s 652 and s 652A Companies Act 1985; distributions to shareholders'), which broadly allows distributions to shareholders on the dissolution of a company to be treated as a capital receipt (liable to CGT in the hands of an individual), rather than an income distribution.

However, comments in a recent consultation document suggest that HMRC may have some reservations about ESC C16 becoming law. It states:

"Initial reappraisal of this ESC led us to believe that the legislation required to formally implement it as it currently stands would significantly increase the length and complexity of the legislation. This is due to the fact that **there would need to be an avoidance rule that prevent the legislation from being used to gain a tax advantage.** HMRC is also mindful of the fact that winding up is the normal process for a company to end its existence and it would be inappropriate for HMRC to seek statutory backing for a practice which encourages companies to accept dissolution in preference to a formal winding up" (emphasis added).

"In addition, HMRC have concerns that ESC C16 has been and continues to be used for avoidance purposes. If ESC C16 were to be legislated it would have to be in a manner that gave no opportunity for abuse."

### What's the problem?

So, one of HMRC's concerns appears to be that ESC C16 is being abused. However, HMRC's policy is that "a concession will not be given in any case where an attempt is made to use it for tax avoidance." Similarly, a concession already given can be withdrawn if it has been abused. If HMRC consider that ESC

C16 is being abused, why are they granting the Concession? Alternatively, if there is evidence that ESC C16 has been mis-used in a particular case, why not simply withdraw the concessionary treatment they have given?

Of course, when ESC C16 becomes law, HMRC will lose the discretion it previously had over whether to grant capital treatment to the taxpayer. As highlighted above, HMRC have indicated that an anti-avoidance rule will also be introduced to prevent the new law being exploited and a tax advantage gained. It therefore seems likely that there will be similar provisions to the income tax anti-avoidance rules regarding 'transactions in securities', so that capital treatment can be denied if the company's dissolution was part of an arrangement that was wholly or mainly to avoid tax.

It also seems likely that any such anti-avoidance legislation will be subject to a statutory clearance procedure. In that respect, the taxpayer would be in a similar position as under ESC C16, in terms of having to ask HMRC for permission to apply capital treatment - a case of 'out of the frying pan, into the fire'!

### What is the real reason?

If HMRC are reluctant to give legislative effect to ESC C16, perhaps a clue to the reason is given away in the following question in the consultation paper:

"Have you any suggestions on ways to legislate this concession without HMRC being seen to be providing statutory backing for a practice, which encourages companies to accept dissolution in preference to a winding up."

There is a non-tax problem with ESC C16. For company law purposes, a 'distribution' does not include the repayment of paid-up share capital, or a distribution of company assets to its members on a winding up (CA 2006, s 829(2)). ESC C16 is a deeming provision for tax purposes. It does not allow assets representing share capital to be distributed, so ESC C16 is

therefore effectively commissioning an unlawful act for company law purposes.

HMRC are therefore in something of a dilemma, as they do not wish to be seen as 'accomplices' to an unlawful act! It will be interesting to see how HMRC deal with this problem when giving legislative effect to ESC C16. One can only hope that there is no adverse effect on what is a very useful, practical provision.

#### 4. Let's be 'reasonable'!

The new penalty regime for errors in tax returns etc is upon us in most cases, as it relates to returns covering periods that started from 1 April 2008, which are due to be filed from 1 April 2009.

The expected effect of the new penalty regime is a higher level of penalties generally than under the previous system. However, no penalty will be charged by HMRC if an error is made in the return despite reasonable care being taken. The question therefore arises: what is 'reasonable care'?

In HMRC's view, it would seem that the standard of reasonable care will vary from person to person, depending on their abilities and circumstances. HMRC state the following in their Compliance Handbook (CH81120):

"For example, we would not expect the same level of knowledge or expertise from a self-employed un-represented individual as we would from a large multinational company. We would expect a higher degree of care to be taken over large and complex matters than simple straightforward ones."

#### Professional advice

HMRC's guidance indicates that if an individual acts on advice from a competent adviser which turns out to be wrong, then reasonable care has been taken and no penalty should be due, provided that the adviser was given the full, accurate facts. The same broadly

applies to advice given by HMRC that proves to be wrong.

Nevertheless, taxpayers and advisers could feel under more pressure than ever before to protect themselves from the risk of a penalty. HMRC offer some comfort on this point (CH81140):

"People do make mistakes. We do not expect perfection." It goes on to say: "We are simply seeking to establish whether the person has taken the care and attention that could be expected from a reasonable person taking reasonable care in similar circumstances." Examples of failure to take reasonable care are included in HMRC's guidance at CH81142.

As in many areas of tax, the question of what constitutes reasonable care is likely to become something of a grey area. This is basically because the answer is a matter of opinion. In cases where the tax treatment of a particular item or transaction is uncertain (after advice from a tax specialist or HMRC), taxpayers should therefore make full disclosure on the tax return and draw the uncertainty to HMRC's attention in the white space. HMRC confirm that in these circumstances the person will have taken reasonable care, and if the tax treatment is wrong it will not be considered careless. Of course, making full disclosure to HMRC's satisfaction is not a straightforward exercise in itself, and extra care will therefore be required.

#### Mark McLaughlin CTA (Fellow) ATT TEP

**Disclaimer** - The information contained in this publication is for general guidance only. You should neither act, nor refrain from acting, on the basis of any such information. Professional advice should be taken based on particular circumstances, as the application of laws and regulations will vary. Please be aware that laws and regulations are also subject to frequent change. Whilst every effort has been made to ensure that the information contained in this publication is correct, neither the author nor his firm shall be liable in damages (including, without limitation, damages for loss of business or loss of profits) arising in contract, tort or otherwise from any information contained in it, or from any action or decision taken as a result of using any such information.