

PRACTICE UPDATE

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1. HMRC...just 'dropping in'!

THE 'HEADLINE GRABBING' proposed changes to the tax system announced in Pre-Budget Report 2007 and Budget 2008 (e.g. CGT changes including a single 18% rate, Entrepreneurs' Relief and the abolition of taper relief and indexation, plus residence and domicile rule changes) have overshadowed some important developments affecting the administration of the tax system.

For example, HMRC issued a consultation document concerning 'Compliance checks' earlier this year. The proposals, if enacted, could be introduced next year. The most significant of the Government's proposals relate to HMRC's information powers. The existing information powers for income tax and CGT purposes (TMA 1970, ss 19-20) would be replaced by new legislation. The same applies for corporation tax and VAT, and it is also proposed that the new powers will support PAYE visits and NIC inspections.

HMRC have indicated that in most cases they will continue to ask for information informally, and add: "In most cases a power will only be formally exercised when information is not provided voluntarily or it is known in advance that it is unlikely to be provided voluntarily."

Information powers

The proposed powers allow an HMRC officer to issue the taxpayer with a notice to supply information and documents if "reasonably required" for "checking the taxpayer's tax position". There are also proposed powers to obtain information and documents from third parties, which extend beyond the current

powers relating to documents (TMA 1970, s 20(3)). The expression "checking" in this context includes any HMRC enquiry or investigation. The draft legislation provides for rights of appeal against taxpayer (or third party) notices.

Powers to inspect businesses

Probably the most controversial (and potentially worrying) proposals for most practitioners are the powers to inspect business premises and assets. These are new powers for income tax, CGT and corporation tax purposes.

The inspection must be reasonably required in order to check a person's tax position. Of course, expressions such as 'reasonably required' are open to interpretation. It seems likely that HMRC will interpret this expression more widely than firms and their clients!

Business assets

The proposed powers allow HMRC to issue a notice requiring the taxpayer (or a third party) to make 'business assets' (i.e. tangible assets, but excluding documents, land and buildings) available for inspection.

Business premises

HMRC's proposed inspection powers apply to the business premises, and to statutory records (i.e. which are required for direct tax or VAT purposes) found on it. HMRC state: "*This power may, exceptionally, be exercised without notice, although visits will normally be arranged in advance*" (emphasis added). The draft legislation provides that at least 24

hours' notice should generally be given, but a draft Code of Practice dealing with HMRC conduct on inspections indicates that HMRC will normally give at least ten days' notice of a visit. Unfortunately, agents will **not** be notified of visits unless the client has specifically asked HMRC to do so. This could be an important issue, as HMRC intend asking 'brief questions' about the nature of the business, and can copy or even 'borrow' some or all of the business records.

HMRC state that visits to business premises without prior arrangement will only take place in 'exceptional' cases based on risk. HMRC officers would first need to obtain internal authorisation at a 'senior level'.

No appeals...but penalties

There would be no right of appeal against an inspection notice. HMRC cannot use the proposed powers to force entry. However, if a client refuses entry to the business premises, HMRC could consider imposing a penalty. The client could appeal against the penalty, but this would probably involve the client in the time, effort and professional costs.

The inspection powers are to be policed internally, rather than externally. There have also been calls during consultation for a post-visit appeal procedure. However, an internal review process is a further cause for concern. How certain can be taxpayers and agents of getting a 'fair hearing'?

What should agents do?

The proposals were subject to a period of consultation, which ended on 6 March 2008. The final provisions will not be introduced until April 2009 at the earliest. In the meantime, watch out for possible further consultations on the proposed powers, and for the final legislation being released. There will also be Codes of Practice setting out the client's rights. Firms should be aware of those rights, so that HMRC's conduct at future inspections can be checked against them.

Two of my articles on HMRC's proposed powers have recently been published, 'HMRC Compliance Checks' (Busy Practitioner, March 2008) and 'An Inspector Calls' (Taxation, 5 March 2008). Please email me if you would like a free copy of these articles.

2. BPR and the two-year rule

IT IS RELATIVELY WELL KNOWN that to qualify for Business Property Relief (BPR) for Inheritance Tax (IHT) purposes, there is a general requirement that the business property must have been owned for a minimum period of two years (IHTA 1984, s 106). However, there are certain exceptions to this basic two-year ownership requirement, in connection with replacement property, acquisitions on death and successive transfers respectively.

Replacement property

With regard to the first of these exceptions (the 'replacement property' rule), the ownership test is treated as satisfied if the property replaced other business property eligible for relief, provided that the combined period of ownership is at least two years out of the preceding five years (IHTA 1984, s 107(1)). However, the BPR available is restricted to what it would have been had the replacement or any one or more of the replacements not been made (s 107(2)). The replacement property rule may be helpful in certain circumstances:

- Incorporation of a business (i.e. the acquisition of the business by a company controlled by the former business owner);
- Partnerships changes - resulting from the formation, alteration or dissolution of a partnership (e.g. retiring from one partnership to form another);
- Company reorganisations, etc – the ownership period of unquoted shares which would (under the CGT rules in TCGA 1992, ss 126-136) be identified with other qualifying shares previously owned may be treated as including the ownership period of the original shares (s 107(4)).

For situations within either of the first two bullet points, the potential restriction in BPR mentioned above is disregarded (s 107(3)).

A recent IHT case (*The Executors Of Mrs Mary Dugan-Chapman & anor v Revenue & Customs Commissioners* (2008) SpC666) concerned a BPR claim that relied on the company reorganisation exception to the two-year ownership rule mentioned above. In that

case, Mrs Dugan-Chapman (Mrs DC) was allotted one million ordinary shares in the company on 27 December 2002, two days before her death. The issue was broadly whether those shares could be identified for BPR purposes with other shares in the company which she had held for at least two years prior to her death.

Unfortunately, the Special Commissioner dismissed the executors' appeal against HMRC's determination that the value of those shares could not be reduced by BPR. HMRC had contended that the shares were issued as the result of a simple subscription for shares. There was insufficient evidence or documentation to support the executors' argument that a reorganisation had actually taken place. For example, only Mrs DC took shares on 27 December 2002. A rights issue would involve the other shareholders renouncing their pro-rata entitlement, so that Mrs DC could acquire the full million shares.

Practical points

Two points from the case may be of possible interest to firms, concerning BPR and also in terms of acting for family and owner-managed companies generally.

- Firstly, 300,000 shares had been allotted to Mrs DC on 23 December 2002 (i.e. six days before her death) as a pro-rata entitlement on a rights issue, following the conversion of a loan account of £300,000 that Mrs DC had with the company. It was agreed that those shares qualified for BPR (i.e. as a result of IHTA 1984, s 107(4)). The case is a useful reminder that director's loan account balances do not qualify for BPR. It also provides a useful potential planning point on how to address this issue.
- Secondly, the executors in the above case stated that the company conducted its affairs with relative informality. They raised the principle established in *Re: Duomatic Ltd* ([1969] 2Ch 365) which broadly allows certain formalities to be treated as satisfied. They argued (unsuccessfully, in the circumstances) that the rights issue had effectively taken place so that events should be interpreted as if it had. However, it may be possible to argue that the *Duomatic* principle applies if, for

example, a director's bonus has not been determined by a company resolution, but had nevertheless been approved less formally by the business owners (see the *Employment Income Manual* at paragraph 42300).

Please contact me if you need any assistance on IHT issues. I am also General Editor of Tottel's Tax Planning Annual, which includes a Chapter from me on BPR.

3. Stop right there!

TAPER RELIEF DISAPPEARS from 6 April 2008. However, it is to be replaced by Entrepreneur's Relief in Finance Act 2008. 'Phoenix' companies therefore look set to continue.

These are broadly companies which are set up to trade for a limited time period (commonly just over two years, under the taper relief regime), before being wound up. The trader would then re-commence the same or a similar business through a new company, and repeat the cycle. However, it seems that HMRC have recently become more alert to phoenix companies.

Part of this process commonly involves an application being made to HMRC under ESC C16 for distributions to shareholders during an informal winding up of the company to be treated like capital payments under a formal liquidation, rather than dividends liable to income tax. Certain assurances must be given as part of the application process, before HMRC will agree to apply ESC C16, which are set out in the concession itself.

Further conditions

In *Taxline* (March 2008), David Whiscombe pointed out: "However we are finding that before sanctioning ESC C16, HMRC are now routinely seeking two additional undertakings not set out in the concession. These are to the effect that:

- the company will not transfer or sell its assets or business to another company having some or all of the same shareholders; and
- the arrangement is not a reconstruction in which some or all of the shareholders in

the original company retain an interest in the second company.”

The first of these additional conditions suggests that HMRC will refuse to apply ESC C16 in a ‘phoenix company’ situation. HMRC’s *Company Taxation Manual* seems to support this treatment. CTM36220 outlines two additional conditions that HMRC will consider before applying ESC C16. One of these is that the company is not the subject of an investigation. The other condition is that:

“The company is not one which, if the distributions were made in a winding up, would be reported to the Anti-Avoidance Group (Intelligence) Clearance and Counteraction Team in respect of Section 703 ICTA 1988 [now ITA 2007, s 684] under subparagraphs (e) or (f) of CTM36875.”

CTM36875 paragraph (e) (now point 5) is:

“The transfer or sale by a company of its assets or business to another company having some or all of the same shareholders followed by a liquidation of the company whose assets etc have been acquired...”

The company owner may decide to incur the additional expense of a formal liquidation, rather than risking a refusal by HMRC to apply ESC C16 and drawing attention to the matter. However, there is still the issue of the ‘transactions in securities’ anti-avoidance rules mentioned above. An ‘ordinary’ liquidation (in which a company is wound up following the complete cessation of business or the transfer of business to unconnected business) is outside the scope of ITA 2007, s 684. However, phoenix companies are potentially caught (see CTM 36850).

Care is therefore needed when dealing with owner-managed companies which are wound up, if the business is to be continued in a newly-formed company. A sale of company shares to another company is also at risk under the transactions in securities rules, if the vendor has a substantial interest in that company. A clearance procedure is available (ITA 2007, s 701), which is particularly important in cases of uncertainty. Please contact me if you need any advice or assistance regarding applications to HMRC under ESC C16, or in respect of clearance

applications under the transactions in securities provisions.

4. Practice Update

Money laundering

Recent changes to the Money Laundering rules (The Money Laundering Regulations 2007) mean that it is necessary to ‘identify’ existing clients (i.e. those who pre-date the introduction of the original regulations, which took effect from 1 March 2004). Recent guidance suggests that new proof of identity may be unnecessary if there is already sufficient evidence on file. However, as a ‘belt and braces’ approach, in my view it is probably better to adopt the same procedures for old and new client firms. May I therefore apologise in advance if it proves necessary to contact you in due course to ask for proof of identity – even if I know who you are!

Terms of business

My firm’s Terms of Business (or engagement) letter has recently been updated in accordance with guidelines issued by the Chartered Institute of Taxation. If your firm receives an updated letter and you have any queries, please do not hesitate to contact me.

Fee rates

From 1 April 2008, the practice’s standard fee rate for tax services increases from £130 to £135 per hour. **Fixed fees at a lower level can be agreed for regular work (e.g. for ‘blocks’ of time, such as one day per month).** Please contact me for further details.

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