

PRACTICE UPDATE

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1. Dividend Waivers – Take Care!

INCOME SHIFTING IS STILL on HMRC’s ‘to do’ list and is expected to be introduced in one form or another from next April, after consultation with the major tax and accountancy bodies.

Unfortunately, it would be a mistake to forget about the ‘settlements’ provisions, as HMRC intend operating both sets of anti-avoidance rules side-by-side. The Income shifting provisions may apply to situations considered to be outside the settlements rules.

One situation where HMRC still seek to apply the settlements rules is dividend waivers between spouses (or civil partners). HMRC may try to argue that there is a settlement if the rate of dividend (including the waived element) exceeds the company’s distributable profits, and the waiver results in a higher level of dividend being received by the lower tax paying spouse. The provisions could result in at least some of the dividend being treated as the income of the spouse who waived their dividend entitlement.

When do the settlement rules apply?

However, the settlements legislation requires that there is a ‘...disposition, trust, covenant, agreement, arrangement or transfer of assets’. The ‘arrangement’ in

HMRC’s view is that one shareholder waives a dividend where another shareholder may benefit. To the extent that an enhanced dividend is received by the other shareholder, that act is regarded as ‘bounteous’. If the other shareholder is a spouse, in HMRC’s view ITTOIA 2005, s 624 (‘Income where settlor retains an interest’) applies. Different settlements provisions may apply if a minor child of the waiving shareholder receives a dividend in similar circumstances.

Consider the facts...

However, as mentioned in my article ‘Say hello, waive goodbye’ (Taxation, 31 July 2008), before conceding that the settlements rules apply to dividend waivers between spouses, it may be worthwhile looking at the particular facts of each case. For example, the dividend waiver may be part of a larger ‘arrangement’ between the spouses, perhaps involving the recipient spouse receiving a salary of less than a commercial rate. Could it be argued that the ‘enhanced’ dividend received should be reduced by the salary not taken, calculated at a commercial rate?

In any event, the settlements rules affecting spouses are broadly intended to prevent tax savings. For example, if both spouses are already higher rate taxpayers, there would seem to be little

point in HMRC seeking to apply the settlements provisions, as there would be no loss of tax for them to recover.

The proposed 'Income Shifting' legislation from April 2009 is not a replacement for the settlements provisions, but is intended to apply in situations where the settlements rules do not. At least the income shifting rules (as presently drafted) will not apparently apply to 'normal commercial arrangements', in terms of the overall income received by each individual.

Further information on the settlements rules can be found in the above Taxation article, which can be accessed via the Mark McLaughlin Associates website:

www.markmclaughlin.co.uk

2. A Useful Exemption

THE IHT REGIME IS GENEROUS in many respects. Aside from business and agricultural property relief at rates of up to 100%, certain categories of exemption and relief are not subject to a fixed upper monetary limit, if the relevant conditions are satisfied. These include:

- Normal expenditure out of income (IHTA 1984, s 21);
- Gifts or legacies to UK-based charities (s 23); and
- Certain 'dispositions' not treated as transfers of value (ss 10-17). These include the waiver of remuneration and dividends, and payments for the maintenance of certain family members, such as relatives who are dependent due to old age or infirmity.

The above exemption for dependent relatives applies to the extent that the disposition represents a 'reasonable provision' for care and maintenance of the relative.

In *McKelvey (Personal Representative of McKelvey Deceased) v Revenue and Customs Commissioners* (2008) SpC 694, the deceased (D) was a spinster who lived with her widowed mother (M),

who was 85 years old, blind and in poor health. D was diagnosed with terminal cancer, and in 2003 gave away two houses that she owned to M. D died in 2005, and M died in 2007.

HMRC sought to charge IHT on the value of D's gift of the houses to M of £169,000. D's executor appealed, on the grounds that the gifts were exempt transfers within s 11(3) as a disposition being a reasonable provision for the care and maintenance of a dependent relative. The executor contended that D gave the houses to M so that they could be sold to pay for nursing care. The executor's appeal was allowed in part. The Special Commissioner held that it was reasonable for D to assume that M would need residential nursing care, and concluded that 'reasonable provision at the time the transfers were made amounted in all to £140,500'. This amount qualified for exemption under s 11, with the balance of £28,500 being a chargeable transfer (s 3A(4)).

What is a 'reasonable provision'?

The difficulty in this case was in determining what was 'reasonably required' for this purpose. HMRC's view of what represents reasonable provision for the care or maintenance of a dependent relative states: "'Reasonable' would appear to suggest such amount as is reasonably necessary for the purpose of providing care and maintenance (but no more), having regard to the financial and other circumstances of the transferor and the relative and the degree of incapacity of infirmity of the latter" (IHTM 04177).

Interestingly, the Commissioner held that, in determining what was reasonably required for M's care: "It seems to me that the approach adopted in personal injury cases is appropriate." This was to take a multiplier of 5.5 (being the assumed number of years that M would have required paid nursing care on the evidence) and an annual care cost in M's own home of £21,000. This resulted in a basic sum of £115,500, to which a further

sum of £25,000 was added to cover a contingency for higher cost if M was admitted to a home.

Further Points

- HMRC guidance also indicates that the dependent relative's incapacity needs to be financial as well as physical (IHTM 04179). Fortunately, the Commissioner did not consider it appropriate to adjust for the mother's own resources, as the deceased's intention was not to meet a financial shortfall, but to replace what she had been doing at no cost to her mother.
- A disposition for the maintenance of family members that does not wholly satisfy the relief conditions may be apportioned (s 11(5)), with the non-qualifying element of a gift to the family member being separately treated as a potentially exempt transfer. In HMRC's view "...an apportionment under s 11(5) is appropriate only where the disposition of an identifiable part of the property transferred completely satisfies Section 11 IHTA 1984." The Commissioner considered that the apportionment provision applied, which enabled the taxpayer's appeal to be allowed in part.

It would seem reasonable to assume that large gifts could be subject to scrutiny by HMRC, in terms of ensuring that the relevant conditions in s 11 are satisfied. Please contact me if you have clients who may benefit from the IHT reliefs and exemptions available. [The above is based on an article produced for 'Busy Practitioner' (Tottel Publishing)].

3. Share Sale 'Trap'

IT IS NOT AN UNCOMMON 'exit' strategy for retiring shareholders to sell their shares to a newly-formed holding company. This can happen in management buyout (MBO) situations, or possibly for tax or commercial reasons of the purchaser. For example, 'Holdco' may

offer shares or cash to all shareholders of 'Tradeco', with the exiting shareholder(s) of Tradeco taking cash, and any remaining shareholders taking shares in Holdco. The share sale is often financed by a loan from the target company to the holding company. As an aside, apart from any company law considerations, for tax purposes it will generally be appropriate to seek clearance from HMRC under ITA 2007, s 701 and TCGA 1992, s 138 in respect of the 'Transactions in securities' and 'Share-for-share exchange' rules respectively.

Section 419(5)

The tax charge on close companies under the 'loans to participators' rules (TA 1988, s 419) is relatively well known and understood. However, the potential for a section 419 charge is less well known in respect of loans between companies. Section 419(5) states:

"(5) Where, under arrangements made by any person otherwise than in the ordinary course of a business carried on by him—

- (a) a close company makes a loan or advance which, apart from this subsection, does not give rise to any charge on the company under subsection (1) above, and
- (b) some person other than the close company makes a payment or transfers property to, or releases or satisfies (in whole or in part) a liability of, an individual who is a participator in the company or an associate of a participator,

then, unless in respect of the matter referred to in paragraph (b) above there falls to be included in the total income of the participator or associate an amount not less than the loan or advance, **this section shall apply as if the loan or advance had been made to him**" (emphasis added).

Applying those conditions to the earlier example:

- Tradeco has made a loan that does not result in a tax charge under section 419(1);

- 'Some other person' (i.e. Holdco) makes a payment to a participator in the company; and
- The loan does not become income of the participator (e.g. as a dividend).

On the face of it, a 25% charge potentially arises for Tradeco, unless the 'loan' is repaid within nine months and a day following the end of the accounting period.

The charge is not widely applied by HMRC, but it is an issue that they are aware of (see the Company Taxation Manual at paragraph 61670).

Preventing the charge

Depending on the circumstances, it may be possible to structure the share sale in such a way that the potential for a section 419 charge does not arise. If this is not possible, or if the deal has already taken place, consideration could be given to whether 'Tradeco' (in the above example) could pay a dividend up to Holdco during the above nine month period, to enable the loan to be repaid. Of course, this will depend upon such issues as Tradeco having sufficient distributable reserves.

If your clients are selling their shares, whether in MBO situations or otherwise, please do not hesitate to contact me to discuss any direct tax issues arising.

4. Associated Companies

THE DIFFERENCE IN corporation tax rates between the main rate (28%) and small companies rate (22%) may be reducing to only 6% from 1 April 2009, but reducing the number of associated companies is still an important planning issue for many small business owners and their advisers.

Business partners

The rules on associated companies (in TA 1988, s 13) are potentially complex, and ascertaining the correct number of such companies can often be time consuming. Fortunately, following a tax simplification

review last year, the Government has made changes to the associated companies' rules. In broad terms, a shareholder is 'associated' with business partners (TA 1988, s 417(3)(a)). Previously, the rights and powers of any business partners were attributed to the shareholder for the purposes of determining whether companies were under common control (TA 1988, s 416(6)).

However, from 1 April 2008, business partners can be excluded for the purposes of determining common control, unless any 'relevant tax planning arrangements' have had effect (i.e. arrangements involving the company, the shareholder and the partner, which secure a tax advantage).

Fewer associates

An effect of this change in the associated companies' rules under TA 1988, s 13 is that because it concentrates on relevant tax planning arrangements involving the company, partnership arrangements (e.g. film partnerships) should not normally be caught be taken into account.

LLP Members

There is some uncertainty about whether LLP members are business 'partners' within the meaning of TA 1988, s 417(3)(a). HMRC have not apparently indicated that LLP members fall outside that definition, and it is hoped that some guidance on the subject will be published sooner rather than later.

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