

PRACTICE UPDATE

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1. 'Reasonable care' - Valuations

Penalties under the new regime can be avoided for inaccuracies in tax returns, provided that 'reasonable care' has been taken. An area of possible contention in tax returns is asset valuations. How far must a taxpayer (or agent) go in order to demonstrate that reasonable care has been taken, where HMRC considers that an asset valuation is too low?

HMRC's Inheritance Tax & Trusts Newsletter (August 2009) features a report on its Annual Probate Section Conference, which indicates that if instructions for the valuation of a property are given on the correct basis, any uplift in value subsequently agreed is 'unlikely' to attract a penalty. The 'correct basis' is defined as:

'...a hypothetical sale in the open market under normal market conditions and marketed property with no discounts for a quick sale or for the time of year etc'.

High standard

It was suggested at the above conference that, in order to be confident that 'reasonable care' had been demonstrated, three valuations from different estate agents were preferable, or a professional (i.e. Royal Institute of Chartered Surveyors) valuation if a definitive valuation was necessary. Rather worryingly, HMRC said that this would only 'go a long way' to demonstrating reasonable care. HMRC stated that they

would also look at what steps were actually taken, and would consider:

- Was professional advice sought?
- Were instructions given on the correct basis?
- Was the valuer's attention drawn to particular features of the property (e.g. development potential)?
- Was anything unusual about the valuation questioned?

Clearly, this implies a high standard of care, and could perhaps be in response to the decision in *Cairns v Revenue & Customs* [2009] UKFTT 00008 (TC), in which HMRC tried to impose a penalty on a solicitor who submitted a professional property valuation as part of an IHT return for a deceased person's estate, which turned out to be too low. The Special Commissioner held that even if the return was incorrect, there was only minor negligence on the grounds that the professional valuation had been heavily qualified and provisionally estimated.

Toolkits

The above comments in the Trusts and Estates Newsletter and the *Cairns* case deal with asset valuations in IHT returns, but should also perhaps be considered in the context of tax returns for individuals and companies as well.

HMRC will shortly be introducing a series of 'toolkits' for agents, which will provide guidance on compliance risks, and '...to set out how agents can reduce the likelihood of mistakes occurring in the returns.' The toolkits will cover risks in

areas including CGT (land and property), CGT for trusts and IHT. It is understood that the use of these toolkits will constitute reasonable care, which therefore suggests that an error in a tax return in an area covered by a toolkit will not be careless for penalty purposes if the guidance in the toolkit has been followed properly.

HMRC states that using the toolkits will ‘...reduce the potential risk of an HMRC enquiry or inspection that could result after an error has been made’. This indicates that the toolkits will also make it more difficult for HMRC to make a discovery outside the normal tax return enquiry window. In the meantime, guidance is available on finality and discovery in self-assessment returns in HMRC Statement of Practice 1/2006.

2. Repairs and Renewals

It is well known that a deduction is generally available from trading profits for expenditure on repairs to fixed assets. However, the position is perhaps less clear in relation to the cost of renewing assets, or so it would seem in HMRC’s view.

When dealing with renewals expenditure, a distinction needs to be made between the costs of replacing the whole of an asset, or only part of it. HMRC states (in BIM46900):

“...some people, for example, use ‘renewal’ to mean either a complete replacement of an ‘entirety’ or a replacement of, or repair to, an ‘entirety’”.

This statement suggests that only the partial replacement of an asset can qualify for a revenue deduction. However, what about the full renewal of assets with only a short useful life? HMRC also states (in BIM35415):

“In some instances a tangible asset may have a very limited economic life. Where the life is less than one year you should accept that expenditure on it is of a revenue nature.”

However, in terms of determining whether expenditure on an asset constitutes plant for capital allowances purposes, HMRC states (in CA21100):

“You should accept that an asset that has an expected life of two years or more (the **2 year test**) is sufficiently durable to be plant”.

In some cases, renewals expenditure which cannot be claimed as a revenue cost may qualify for 100% capital allowances under the ‘Annual Investment Allowance’ provisions instead.

Integral features

Special rules apply to certain expenditure (e.g. repairs) on integral features in buildings etc, such as lighting or water heating systems (CAA 2001, ss 33A-B). In broad terms, if the amount of such expenditure is more than 50% of the cost of replacing the integral feature, it is treated as being in respect of a replacement (i.e. a capital cost, rather than revenue expenditure). Integral features qualify for capital allowances, but at a ‘special rate’ of 10%.

The ‘renewals basis’

In the case of furnished lettings, it can be possible to claim a deduction for the cost of renewing furniture, furnishings and chattels. ESC B47 states that the cost of the original cost of the original items is not allowable, but the cost of renewing them is allowable.

ESC B47 also deals with the 10% ‘wear and tear’ allowance, which is an alternative to claiming a deduction for the costs of renewing furniture, furnishings or chattels such as suites, carpets or cookers (nb capital allowances cannot be claimed for expenditure on plant and machinery for use in a let dwelling house (CAA 2001, s 35(2)). ESC B47 is being withdrawn, but is expected to be replaced by legislation allowing taxpayers to elect for the 10% wear and tear allowance.

However, the renewals basis is a separate concessionary practice to wear and tear

allowance. HMRC is still considering the future of the renewals basis, and a further announcement will be made in due course. In the meantime, the draft legislation on wear and tear allowance is available via the Chartered Institute of Taxation's website:

<http://www.tax.org.uk/attach.pl/8335/9810/ExtraStatutoryConcessionsCondoc150709.pdf>.

3. Asking HMRC

We all know that tax is full of grey areas, and probably often wish that we knew with certainty in advance about the tax treatment of a particular transaction. However, would you consider asking HMRC for that certainty?

Various facilities are available to obtain clearances and rulings from HMRC on the tax treatment of various transactions. These include:

- HMRC Code of Practice 10 - 'Information and Advice' (<http://www.hmrc.gov.uk/pdfs/cop10.htm>);
- Statutory Clearances, such as in respect of purchases of own shares by unquoted trading companies, or company reorganisations and demergers (for further details, see <http://www.hmrc.gov.uk/cap/statutory-clearances.pdf>);
- VAT rulings (VAT Notice 700/6);
- An informal clearance service for businesses (for further information, see (<http://www.hmrc.gov.uk/cap/links-dec07.htm>); and
- An Inheritance Tax clearance service for business owners (see <http://www.hmrc.gov.uk/cap/links-dec07.htm>).

Tips for asking HMRC

It is essential that applications for advice, rulings and clearances are properly made. It is equally important that HMRC's response is retained on file and, if given verbally, is immediately recorded in writing (verbal advice is probably best avoided if at all possible, as illustrated in the recent

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case *Corkteck Ltd v HMRC* [2009] EWHC 785 (Admin).

HMRC provide detailed guidance on the suggested format and content of clearance applications in some of the sources of information listed above. This guidance should be followed carefully. However, bear in mind that circumstances vary and HMRC's guidance may not cover all cases. The format and content of clearance applications should therefore be adapted accordingly.

Applications should be drafted very carefully. Practitioners should follow the principle established in *R v Inland Revenue Commissioners, ex p. MFK Underwriting Agencies Ltd* ([1989] STC 873) that the taxpayer "...should have put all his cards face upwards on the table".

It goes without saying that if an application is materially incomplete or incorrect, any clearance or ruling given by HMRC on the basis of that application cannot be relied upon.

[The above article is adapted from my article in 'Busy Practitioner' for July / August 2009, which is published by Bloomsbury Professional.

4. New Dividend Rules

Accountants and tax advisers who were familiar with the concept that a dividend paid by one UK company to another UK company was not generally liable to corporation tax will need to think again, following legislation introduced in Finance Act 2009.

Bad news or good news?

Under the new rules, the basic position is that all distributions paid on or after 1 July 2009 are liable to corporation tax, regardless of whether it is paid by a UK resident or foreign company.

However, this is not necessarily the bad news that it first seems. The new rules contain various exemptions from a corporation tax charge. In practice, the new legislation will result in the vast

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majority of dividends between UK companies continuing to be exempt as before. In addition, many dividends paid by non-UK resident companies to UK resident companies will no longer be liable to corporation tax.

Small companies

There is a specific exemption for distributions received by small companies, if certain conditions are satisfied. These are broadly (CTA 2009, s 931B):

- The paying company is resident in either the UK or in a 'qualifying territory' (as defined), and is not also dual resident.
- The payment must not be an amount of interest that is treated as a distribution for tax purposes (under ICTA 1988, s 209(2)(d) or (e)).
- A deduction is not allowed to any foreign resident in respect of the distribution.
- The distribution is not paid as part of a 'tax advantage scheme' (as defined).

A 'small company' for these purposes is broadly one with less than 50 staff, and either a turnover or balance sheet total of not more than 10 million Euro. Any 'partner' or 'linked' enterprises are also taken into account, and certain types of company (e.g. authorised unit trust schemes) are not treated as 'small' for these purposes (CTA 2009, s 931S).

Other companies

For companies other than small companies, three conditions must be satisfied for distributions to be exempt:

- The distribution falls into an exempt class.
- The payment must not be an amount of interest that is treated as a distribution for tax purposes (under ICTA 1988, s 209(2)(d) or (e)).
- A deduction is not allowed to any foreign resident in respect of the distribution (CTA 2009, s 931D).

In addition, the distribution must not be prevented from falling into an exempt

class because of certain anti-avoidance rules included in the new legislation.

There are five exempt classes:

- Distributions from controlled companies.
- Distributions in respect of non-redeemable ordinary shares.
- Distributions in respect of portfolio holdings.
- Dividends derived from transactions not designed to reduce tax.
- Dividends in respect of shares accounted for as liabilities.

For client companies which are not 'small', the first two exemptions above are likely to be most common. A dividend would only need to fall into one of the exempt classes, unless an anti-avoidance rule applies.

A good thing?

The new regime will no doubt be welcomed by most UK companies in receipt of dividends from foreign subsidiaries, who (subject to the anti-avoidance rules) can now treat those dividends as free of UK tax.

In the case of (for example) dividends received from other UK companies, in most cases there will be no corporation tax liability. However, whereas previously such dividends were automatically exempted from corporation tax, it will now be necessary to check the legislation to ensure that the distribution falls within one of the exempt categories, and is not caught by an anti-avoidance provision.

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