Technical Connection

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INTEREST STATEMENTS

This is the time of year when banks and building societies issue statements of tax deducted from interest paid (section 975 ITA 2007 statements) in the tax year 2011/12 on continuing accounts. Many depositors rely on these when completing their tax return, rather than searching through their regular account statements for interest payments.

It would appear that this approach to completing tax returns is not without a serious risk. The reason is simple: not all deposit takers provide details of interest earned on accounts which were closed during the tax year, even though closure will normally have triggered a final interest payment. The same problem can occur with online interest information.

With many accounts relying on limited term bonus payments to produce competitive rates, canny investors will often churn their accounts, sometimes with the same provider. These cases need extra care as they could lead to an understatement of interest earned.

INHERITANCE TAX/CAPITAL GAINS TAX PLANNING FOR BUSINESSES

What can go wrong if a business owner dies unexpectedly and this has not been planned for

We all have clients who run businesses. Should those businesses become successful there is a good likelihood that the business will be sold. Normally, certain tax reliefs will be available at such time, most notably capital gains tax (CGT) entrepreneurs' relief, which can reduce the CGT liability to 10%. More substantial reliefs are available if a business owner dies - most notably inheritance tax (IHT) business property relief at 100% (or 50%) and a market value revaluation for CGT purposes. However, a recent tax case shows how planning can go horribly wrong if a business owner dies unexpectedly and this has not been planned for.

The case involved a business owner called Mr S. Mr S's daughters lost a considerable part of their inheritance because he died suddenly during heart surgery in February 2007, just two weeks after selling his photographic wholesale business for £3.5 million.

He and his daughters (who were part owners of the business) had engaged a law firm to advise them on the deal. A senior solicitor at the law firm also provided Mr S with some personal tax advice.

The disposal incurred a CGT charge of about £160,000. His sudden death also gave rise to a £1 million IHT bill.

His daughters' case was that the law firm should have advised Mr S to defer the sale of the business until after his heart surgery. In that case the business would still have been part of his estate at his death, and as an unquoted qualifying trading company it would have attracted 100 per cent IHT business property relief - thus the IHT charge could have been avoided.

Moreover, there would have been a deemed disposition and reacquisition of the shares at the date of his death at market value so no CGT would have been payable either (except for CGT on any increase in value after his death).

Mr S's daughters claimed that the law firm were aware of the impending heart operation and that the firm's failure to guard against the risk of death cost them £1.3 million - about 30 per cent of their father's estate. The law firm rejected the claim, saying it was "a bad claim based on hindsight".

The family lost its claim in the High Court in February last year. Whilst Mr. Justice Arnold said "... it would be entirely understandable if the family were left with a strong feeling that they had been ill-served by the legal profession", the taxpayer lost the case. The High Court judge decided that the law firm's retainer was limited to advising Mr S and his daughters on the tax consequences of the sale itself, not on how the transaction fitted into their personal financial and tax planning positions. The judge also considered that the law firm had only learned about the heart operation by chance, which absolved them from any duty to advise the S family about its possible tax consequences.

Regarding costs, though, the judge adopted an "issues-based" approach. He granted the law firm only 50 per cent of its costs, because it had refused to accept any form of mediation.

The daughters then went to the Court of Appeal, where their case was based partly on the fact that Mr. S e-mailed one of his daughters about his coming operation and copied it to a solicitor at the law firm. This should have prompted the law firm to give Mr S legal advice about the possible consequences if he died, the daughters claimed.

The Court of Appeal dismissed a professional negligence claim by the heirs of Mr S against the law firm (Mason v Mills & Reeve, 2012 EWCA Civ 498). The Appeal Court decided that "there is nothing to suggest that Mr. S had any particular intention to convey the information [about the heart procedure] contained in that e-mail. On the contrary ... it appears to be pure happenstance that the chain included the information about the heart procedure." The judge observed also that the e-mail exchange was copied to the corporate finance partner involved in the transaction, not the tax lawyer with whom Mr S had been corresponding directly, and that there was nothing in that e-mail to indicate that the heart procedure was anything other than a routine procedure. Thus the solicitors had **not** been negligent.

The Court of Appeal disagreed with the High Court in one respect, regarding costs. It increased from 50 per cent to 60 per cent the costs award in the law firm's favour, and said the High Court had been wrong to criticise the firm's refusal to go to mediation.

This is an interesting case. Mr S left his shares to his daughters on his death. He was separated from his wife. Had he not been separated and had left all his shares to his wife, although CGT would have been payable on the sale, for IHT purposes the spouse exemption would have applied and no IHT would have been payable.

This clearly raises some important points to bear in mind when a client who is in ill health is about to sell a business. Indeed, certain parallels can be drawn with situations where a shareholder in a private business dies having set up a business succession arrangement. In those circumstances no IHT will arise if either

(a) the deceased's shares pass to a spouse or

(b) the shares are subject to a double option agreement and so qualify for 100% business property relief (BPR).

Clearly, if (a) does not apply it is imperative to make sure that there is a double option agreement in place rather than a binding contract for sale to ensure entitlement to full BPR is not compromised.

Even if the shares pass to the deceased's spouse and so no IHT in any event applies, he/she will then own cash. This means that if the surviving spouse does die a short time thereafter, the whole of this cash sum will potentially be subject to IHT (in what would be a similar position to that of Mr S).

To avoid this situation, the shareholder should leave his shares to a spousal by-pass trust via his Will so that, when the shares are subsequently sold by the estate to the continuing owners, the sale proceeds are:-

- not in the survivor's estate for IHT purposes yet

- the spouse, as a beneficiary, will have access to income/capital from the trust from time to time via the trustees exercising their discretion.

As the Mr. S case demonstrates, it pays to tie up all of the loose ends when combining business succession planning with tax-efficient estate planning.

SDLT THRESHOLDS

A recent Tribunal hearing has underlined the dangers in fixing a price at an SDLT threshold level

Stamp Duty Land Tax (SDLT) is a ‘slab’ tax, which most experts agree is a poor design for any form of taxation. Thus, at current rates the following anomalies exist:

Price **£**	**SDLT** **£**	**Price + £1** **£**	**SDLT** **£**	**SDLT for extra £1** **£**
125,000	Nil	125,001	1,250	1,250
250,000	2,500	250,001	7,500	5,000
500,000	15,000	500,001	20,000	5,000
1,000,000	40,000	1,000,001	50,000	10,000
2,000,000	100,000	2,000,001	140,000	40,000

Not surprisingly, very few properties sell at prices just above the SDLT thresholds and there is a bunching at or below. Often, where a property is marketed initially at an above-threshold price, the purchase contract ends up as a combination of:

- SDLTable property sale at or just below the threshold; and
- Non-SDLTable chattels.

There has always been a risk in this approach that HMRC will challenge the validity of the chattels list because it may only require a nominal extra amount allocated to ‘land’ rather than ‘chattels’ to produce a significant increase in SDLT payable.

Just such a challenge has found its way to the First-tier Tribunal in *Orsman v HMRC*. Miss Orsman bought a property in Brighton for £250,000 and paid an additional £8,000 for chattels. HMRC raised questions about the list of ‘fixtures and fittings’ included in the sale contract, expressing concern about

- fitted units and worktop in the garage (valued at £800);
- an electric oven and hob; and
- three semi-fitted wardrobes.

After some discussions HMRC agreed that the wardrobes and oven and hob were sufficiently movable not to count as ‘land’ for SDLT purposes. However, the garage units were ‘land’ in HMRC’s view because they were surmounted by a worktop fixed on battens mounted to a wall and could not be removed without damage to the structure of the house.

The Tribunal agreed, although it noted HMRC had seemingly accepted as chattels the up and over garage door motor, the front doorbell and recessed down lighters. Miss Orsman was left with an extra £5,024 SDLT to pay.

COMMENT

There is always a temptation to think that HMRC won’t bother to look too closely or fight that hard for relatively modest amounts of tax, especially if it means a Tribunal hearing. This is a reminder that, at least in the SDLT area, such an assumption is dangerous.

RDR AND ELIGIBILITY FOR SOME STOCKS AND SHARES ISAs

HMRC's latest ISA bulletin has raised the question of eligibility for stocks and shares ISAs of some funds post the Retail Distribution Review (RDR).

The issue revolves around the '5% test', which states that for an investment to be eligible for a stocks and shares ISA, at the date of purchase:

- there must be no guarantee or agreement that the investor would receive 95% or more of their purchase price at any time in the next five years, or

- the nature of the investments held must not significantly limit the risk to the investor's capital to 5% loss or less at any time in the next five years.

The test compares the price paid by the investor for the investment with the amount receivable on the sale. It thus applies *after* any initial, terminal or regular charges. If the investor is 'certain or near certain' to receive 95% or more of their original purchase price, then the 5% test is not satisfied. Depending upon its nature, the investment may alternatively qualify to be held in a cash ISA.

HMRC is concerned that post RDR some funds, which currently carry sufficient charges to pass the 5% test, will no longer do so. It quotes the example of a fund with an initial charge reduced to 0.5% post RDR, but retaining a guarantee that losses will be capped at 3%.

Existing ISA rules already prevent a stocks and shares ISA manager from acquiring securities which have less than five years to run to redemption, hence the widespread use of terms just exceeding five years for ISA-wrapped structured products.

COMMENT

Quite where HMRC is coming from is unclear. The bulletin states that 'Government securities funds or certain corporate bond funds, or funds that guarantee a return to investors' may be affected, but nobody yet appears to have discovered a fund that passes the 5% test now, but looks set to fail post RDR.

ECJ JUDGEMENT ON VAT AND DISCRETIONARY FUND MANAGEMENT SERVICES

Advocate General, Eleanor Sharpston, has made it clear in the ECJ opinion statement on the (German) Deutsche Bank case, issued on the 8th of May, that :

1. Charges made for all elements of the services provided by a Discretionary Fund Manager (DFM) should be subject to VAT.

2. Individual services (eg transaction fees and commissions for executing trades) should not be disaggregated from the overall service to be VAT exempt. This was because where a "bundle of services " was provided it was essential to look at the overall supply to determine whether there was a single composite supply or a series of independent transactions. In particular, a series of separate transactions should be regarded as a single supply where they

were not independent. In the case under consideration such a composite, single supply was deemed to exist and this supply was wholly subject to VAT.

3. The case would be referred back to the German court to consider taking account of the EJC's finding. It is usual for local courts to follow the ruling of the ECJ.

In the UK, under the VAT Act 1994, discretionary services are subject to VAT but charges and commissions for executing trades are exempt. This is reaffirmed in the HMRC VATFIN Manuals. However, HMRC has recently stated that its position in relation to VAT and DFM charges going forward would be influenced by the ECJ statement - which we now have.

To date, in the UK, the principle of 'disaggregation' has offered the opportunity to provide VAT exemption on the transactional element of DFM charges. On the assumption that the operating model and overall supply takes a similar form to that in the Deutsche Bank case, then this would now look to be in doubt. The view taken by the Advocate General appears to be founded on a "substance over form" approach looking at the overall supply, and especially whether any of the services within that overall supply could be considered as genuinely and economically independent.

In some respects the approach is not unlike the initially (apparently) favoured approach in relation to adviser charging founded on the "predominant purpose" of an overall supply. Thankfully, in relation to adviser charging, this principle does not form the basis of the new guidance.

The full implications of this latest ECJ ruling are yet to be established but many advisers will be surprised that VAT will be applied to all DFM charges. Clearly they will not help the investor who will ultimately bear the cost of the charge – whether it is paid directly or indirectly (by the product provider).

10% REDUCTION IN IHT FOR BEQUESTS TO CHARITY

With effect from 6 April 2012, the Government introduced new IHT legislation that can affect anyone planning to pass a proportion of their estate to charity. Gifts to charity are already exempt from IHT, but the new rules mean that the rate of IHT on the rest of the estate can be reduced from 40 per cent to 36 per cent. So, although the charity will receive the same amount, the non-charitable heirs should be better off under the new measures because less IHT is paid on what they receive.

However, the new rules are relatively complex. On death, an estate will be divided into 3 different components for IHT purposes - each of which needs to be looked at separately. These are:

- property held jointly as joint tenants – the "survivorship" component;
- property held in a trust that is treated as part of the estate for IHT purposes – the "settled property" component; and
- a "general" component - which is essentially everything else (ie. the residuary estate).

Within each of these components, any reliefs or exemptions - such as the available proportion of the nil rate band - will be deducted first to ascertain the chargeable element. The charitable gift is then added back in to give the "baseline amount". If more than 10 per cent of the baseline amount within one component passes to charity, then the reduced rate of 36 per cent will apply to the rest of the assets within that component.

So, let's take a case where Jane, a widow, dies after 5 April 2012. All of her husband's estate passed to her on his death three years ago. She has an estate of £l million. None of this is made up of property held in joint tenancy or property she has an interest in via a trust. Her Will leaves £50,000 to charity and the rest of the estate to her children. After her nil rate band and her husband's transferable nil rate band, totalling £650,000, are taken into consideration, the baseline amount here would be £350,000. As the £50,000 charitable gift exceeds 10% of the baseline amount, the reduced 36% rate of IHT will apply to the estate passing to the children.

As a result:

- the IHT liability is reduced to £108,000 (36% of £300,000) instead of being £120,000 (40% of £300,000)

- the charity receives £50,000; and

- the children receive £842,000 - which is £12,000 more than they would have received under the previous rules.

The calculation is more complex where there is more than one component of the aggregate estate. This is because the 10% test will be applied to each component separately. The value of the assets passing to charity from a particular component will be compared to the baseline amount for that component. If the 10% test for a component is passed, IHT will be charged on that particular component at 36%.

For example, let's assume that rather than being owned by Jane outright, some of the assets of her estate for IHT purposes, say £500,000, were held in an immediate post-death interest trust (created by her husband when he died 3 years ago) and the charitable gift under Jane's Will was £22,000 rather than £50,000.

Jane's estate would now be made up of two components - a £500,000 settled property component and a £500,000 general component. The available nil rate band of £650,000 is apportioned equally between these two components. The baseline amount for the general component, out of which the charitable gift is made, would therefore be £175,000. As Jane's charitable gift of £22,000 exceeds 10% of £175,000, the reduced rate would apply to the assets passing under her Will. However, the full 40% rate will apply to the assets passing under her husband's Will trust because none of this is subject to a charitable gift. It will be noted that even though £22,000 is less than 10% of the aggregate baseline amount of £350,000, a reduction in IHT has still been achieved by the estate being divided into 2 components.

If the assets passing to charity from one component are 10% or more of the baseline amount, other components may be merged with it to give an aggregate baseline amount. For example, if Jane did not reduce her gift to £22,000 (above) but kept it at £50,000 this would be more than 10% of the baseline amount of both the settled property and general components added together which is £350,000 (2 x £175,000). In such a case an election should be made to "merge" the two components. By doing this the reduced IHT rate would apply to both her free estate and the trust assets. Without such an election only her free estate would enjoy the reduced rate, the 40% rate then applying to the trust.

COMMENT

The new relief is useful for anybody who intends to leave some of their estate to charity. Professional advice should be taken to ensure that, based on the different components in the estate, the Will is drafted in such a way that the 10% reduction in IHT applies. Financial advisers will need to bear in mind the reduced rate in calculating the potential IHT liability on somebody's taxable estate for life cover purposes.

HMRC LAUNCHES NEW QROPS ATTACK

From 6 April 2012 the Government made several revisions to the rules for Qualifying Recognised Overseas Pension Schemes (QROPS). These changes were to ensure that QROPS meet what HMRC regards as their intended purpose, ie to allow individuals leaving the UK to take their pension savings with them to their new country of residence and provide an income there. What HMRC was trying to block was the use of QROPS to convert existing UK pension saving into a lump sum or to escape the normal UK taxation of pensions applicable to UK residents.

These new rules included a new application procedure for those individuals wishing to transfer their UK pension benefits to a QROPS and new reporting obligations for the provider of the QROPS. In addition, there is a new requirement that has to be met if a scheme is to qualify as a QROPS, or continue to be regarded as a QROPS, on or after 6 April 2012: the tax reliefs and tax exemption on contributions, build up and receipt of benefits for the QROPS must apply equally to non-resident and resident scheme members.

Prior to these changes, Guernsey had been one of the most popular jurisdictions for QROPS. However, the new requirement for equal treatment of non-resident and resident scheme members meant that very few existing Guernsey-based QROPS could retain such status after 5 April 2012. As this represented a potential significant loss to the Guernsey financial services sector, its Parliament introduced a new section 157E pension plan, which provides for pensions to be paid free of Guernsey tax to residents and non-residents, and would seemingly meet the new criteria to be a QROPS. HMRC felt that the new section 157E plans were still, in practice, designed as a vehicle for non-residents (as they had several features which meant they were unlikely to be taken out by Guernsey residents) and to encourage transfers from UK schemes primarily for tax reasons. It has therefore introduced new legislation that specifically excludes 157E plans from being QROPS.

This further action by HMRC highlights its intention to restrict QROPS to their original purpose. It also means that if a client wishes to transfer their benefits to a QROPS it is essential to obtain professional advice on the effectiveness of such an arrangement as well as the new application procedure.

INCOME WITHDRAWAL RATE FOR JUNE 2012

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in June 2012 is 2.25%.