Management of taxes

KEY POINTS

- HMRC have powers to enable them to obtain information and documents from taxpayers and third parties, and to inspect business premises, business assets and statutory records. There are various restrictions on HMRC's powers and a penalty system for non-compliance and the provision of inaccurate information (see 350ff.).
- The main penalty provisions in relation to enquiries apply to: incorrect returns and documents; failure to notify liability; and late filing and payment. The rules apply standard percentages of the potential lost revenue to determine the penalty for three distinct categories of behaviour and then provide reductions to reflect the extent of disclosure (see 530ff.).
- Taxpayers have various record keeping obligations (see 970ff.).
- Appropriate use of the white space section of a tax return (or a note in a computation) can reduce the risk of an enquiry. It can also limit the risk of a discovery by HMRC (see 1000ff.).
- In recent years, the Government has introduced many provisions in an attempt to prevent tax avoidance and evasion (see 1030ff.).
- Practitioners need to understand the appeals process, including: the statute-based internal review of HMRC decisions; the Alternative Dispute Resolution process; and the workings of the tribunal system (see 1120ff.).
- HMRC are able to make enquiries into a return without any need to demonstrate grounds for dissatisfaction (see 1240ff.).
- The Government plan to move to a fully digital tax system though their making tax digital initiative (see 2390).

Information and inspection powers

350 Information and inspection powers – overview

HMRC's information and inspection powers include:

- requiring a person in receipt of a 'taxpayer notice' to make available information and documents reasonably required to check the person's tax position;
- requiring a third party in receipt of a 'third party notice' to produce documents or provide information about named or unnamed taxpayers;
- requiring a person to give HMRC access to business assets, business documents and premises if reasonably required to check the person's tax position;
- requiring an 'involved third party' to give HMRC access to business assets, business documents and premises if reasonably required to check a person's (or a class of persons') tax position; and

There are various restrictions on HMRC's powers. For example a person is only required to produce a document if it is in their possession or power.

A person can generally appeal against a taxpayer notice or any requirement in the taxpayer notice. But there is no right of appeal against the requirement to produce statutory records or against an information notice approved by the tribunal.

A person can appeal against a third party notice or any requirement in the notice if it would be unduly onerous to comply. But again there is no right of appeal against the requirement to produce statutory records or against an information notice approved by the tribunal.

HMRC can charge penalties if a person:

- fails to comply with an information notice or obstructs an inspection approved by the tribunal; or
- complying with an information notice provides inaccurate information or produces a document that contains an inaccuracy, and either:
  - the inaccuracy is careless or deliberate;
  - the person knows of the inaccuracy at the time the information is provided or the document is produced but does not tell HMRC at that time; or
  - the person later discovers the inaccuracy and fails to tell HMRC.

If an information notice has been approved by the tribunal (or if the officer has indicated an intention to seek such approval), the subsequent concealment, destruction or disposal of a document constitutes a criminal offence. A person guilty of the offence is liable on indictment to imprisonment for a term not exceeding two years or to a fine, or to both.

Legislation: FA 2008, Sch. 36

HMRC Manuals: CH20000ff.

In-Depth: ¶186-550ff.

355 Information and inspection powers – relevant taxes

The information and inspection powers apply to:

- income tax (including employers' obligations to deduct and account for PAYE & NIC);
- National Insurance contributions;
- deductions under the Construction Industry Scheme;
- capital gains tax;
- corporation tax (including any amount assessable or chargeable as it were corporation tax);
- diverted profits tax;
- apprenticeship levy;
- VAT (as defined);
- insurance premium tax;
- inheritance tax;
- stamp duty land tax;
- stamp duty reserve tax;
- annual tax on enveloped dwellings
- petroleum revenue tax;
- aggregates levy;
- climate change levy;
- landfill tax;
- relevant foreign tax (as defined); and
- bank payroll tax.

Legislation: FA 2008, Sch. 36, para. 63; FA 2010, Sch. 10, para. 36

HMRC Manuals: CH21050

In-Depth: ¶186-550ff.

380 Information powers

The powers enable HMRC to issue a formal notice to a taxpayer (a taxpayer notice) requiring them to provide information and documents reasonably required to check their tax position. There does not have to be an open enquiry except where a return has been submitted and the enquiry window is still open. The items will usually be requested informally in the first instance.

There is an important distinction in the application of the powers as between matters which are and are not part of a business's statutory records. That term is loosely defined but precisely what forms part of a particular person's statutory records will depend on the person's circumstances.

There is no right of appeal against a notice requiring the provision of statutory records. By contrast, there is a right of appeal against a notice requiring the provision of supplementary information and documents if the taxpayer does not agree that they are reasonably required.

The officer can issue as many information notices as necessary throughout the course of an enquiry. It would be normal for an informal request for the information to be made in each case.

Legislation: FA 2008, Sch. 36, Pt. 1, 4, 5 and para. 62; TMA 1970, s. 12B

Cases: *Couldwell Concrete Flooring Ltd* [2015] TC 04340; *Mathew* [2015] TC 04342; *PML Accounting Ltd* [2015] TC 04612; *Qualapharm Ltd* [2016] TC 04891; *Alvi* [2016] TC 04989; *Cherian* [2016] TC 05085; *Gold Nuts Ltd* [2017] TC 05602; *New Way Cleaning Ltd* [2017] TC 05769; *Gold Nuts Ltd* [2017] TC 05828; *Nicol* [2017] TC 05978; *Codexe Ltd* [2017] TC 06014

HMRC Manuals: CH21150; CH21700

Other Material: GOV.UK website: Business records if you're self-employed; Running a limited company

In-Depth: ¶186-550ff.

385 Private records

HMRC can use their information powers to request private records, including bank and building society statements, paying-in slips and details of property or other assets. The information or documents requested must, however, be reasonably required for checking the taxpayer's tax position. HMRC consider that reasonable equates to 'fair and sensible' in the circumstances. Whether a request is reasonable is, therefore, dependent on the circumstances in each case.

As private records do not form part of the statutory records they are supplementary information. There is, therefore, a right of appeal against a notice requiring them. The onus will be on the officer to satisfy the tribunal that the information is reasonably required.

When requesting private records, HMRC acknowledge the need to take account of:

- the cost – for example the cost of obtaining duplicate bank statements; and
- the taxpayer's right to privacy – the officer must be able to demonstrate that seeing the private records is an effective way of checking the person's liability to tax and that it will cause the minimum necessary intrusion into their private lives.

As a practical point, clients should always be advised to operate a separate business bank account so that they cannot be required to immediately produce their private records at the start of an enquiry.

HMRC cannot use an information notice to require a person to provide or produce records concerning their physical, mental, spiritual or personal welfare ('personal records').

Where 'personal records' contain mixed information, HMRC can require the person to provide the information that does not relate to their welfare.

Legislation: FA 2008, Sch. 36, para. 1 and 19(2), (3); *Police and Criminal Evidence Act* 1984, s. 12

Case: *Long* [2014] TC 03339

HMRC Manuals: CH22180; EM1561

In-Depth: ¶186-625

390 Restrictions on taxpayer notices

There are a range of restrictions on the requirement to provide or produce information or documents. In summary, a person cannot be required to provide or produce:

- a document that is not in his or her possession or power;
- information relating to the conduct of a pending tax appeal;
- journalistic material in the possession of the person who acquired or created it;
- personal records concerning the health, spiritual or welfare counselling or assistance in respect of an individual but note that provision is made for the editing out of such information from general records;
- documents more than six years old unless the notice is given by or with the agreement of an 'authorised officer';
- information for the purpose of checking the tax position of someone who died more than four years before the date of the notice;
- information or any part of a document that attracts legal professional privilege;
- subject to significant limitations, information held by that person in connection with his or her performance of a statutory audit or documentation created by him or her or on his or her behalf in connection with that function ; and
- again subject to significant limitations, information held by a tax adviser about 'relevant communications' or documents belonging to the tax adviser, which are communications between the tax adviser and his client or any other tax adviser of the client (but note that the same communications in the hands of a client are not protected).

The restrictions and limitations can be applied in an appropriately selective manner where some information is and some is not protected.

Legislation: FA 2008, Sch. 36, Pt. 4, para. 18–28

HMRC Manuals: CH22000ff.

In-Depth: ¶186-600ff.

395 Taxpayer notices following tax return

The legislation specifies restriction of HMRC's powers where a return has been made in respect of the relevant chargeable period but in reality the provision means that an information notice may be issued to a taxpayer

notwithstanding that he has made a tax return in respect of the relevant chargeable period in any of the following circumstances:

- there is an open enquiry;
- an HMRC officer has reason to suspect that circumstances would permit the making of a discovery assessment; or
- the notice is given for the purpose of obtaining any information or document that is also required for the purpose of checking that person's VAT, PAYE or CIS position.

Legislation: FA 2008, Sch. 36, para. 21

Case: *Betts* [2013] TC 02824

HMRC Manuals: CH23526

In-Depth: ¶186-550ff.

400 Third party notices

HMRC's powers extend to obtaining information and documents from third parties. The purpose of a third party notice is the same as that for a taxpayer notice; the information or document has to be reasonably required for the purpose of checking the tax position of the relevant person.

There are additional constraints upon the issue of a third party notice. Except in relation to information that forms part of any person's statutory records and relates to the supply of goods or services (or certain imports), a third party notice can only be issued with either the agreement of the taxpayer or the approval of the tribunal.

The National Crime Agency is also entitled to apply to the tribunal for permission to issue a third party information notice where it has taken over all the 'general Revenue functions' in relation to a taxpayer.

Legislation: FA 2008, Sch. 36, para. 3; FA 2011, Sch. 23; PCA 2002, s. 317

Cases: *PML Accounting Ltd* [2015] TC 04612; *Re an application by R & C Commrs* [2015] TC 04649; *National Crime Agency, ex parte a taxpayer* [2016] TC 05191

In-Depth: ¶186-550ff.

R & C Commrs v Tager (Personal Representatives of the Estate of Tager (deceased)) was the first case in which a tribunal considered an application by HMRC for the imposition of a 'tax-related penalty', for failure to comply with an information notice. The tribunal determined that the starting point for each penalty was 100% of the tax at stake and imposed a penalty of £1.17m representing 100% of the inheritance tax at stake (as calculated by HMRC) with no mitigation and a further penalty of £75,000 representing 100% of the income tax at stake (£80,549) with mitigation of a modest rounding down only.

No penalty should be imposed while the appeal period is still open or if an appeal has been made against the notice and the appeal is still open.

In addition to any non-compliance penalty, failure to comply with an information notice may limit the practitioner's scope to argue for a reduction of any penalty charged in respect of any inaccuracies found in a return.

Legislation: FA 2008, Sch. 36, para. 39, 40, 49A, 50

Cases: *R & C Commrs v Tager (Personal Representatives of the Estate of Tager (deceased))* [2015] BTC 509; *PML Accounting Ltd* [2015] TC 04612; *Doshi* [2016] TC 04813; *Spring Capital Ltd* [2016] TC 05007; *Cherian* [2016] TC 05085; *R & J Birkett (t/a The Orchards Residential Home) v R & C Commrs* [2017] BTC 511

HMRC Manuals: CH26220

In-Depth: ¶187-075

425 Tribunal approval

HMRC can seek advance approval of the tribunal for an information notice. There is no right of appeal against a taxpayer notice that has been approved by the tribunal.

If HMRC want to inspect documents and business premises at the same time, they can ask the tribunal for their approval for both the inspection visit and the taxpayer notice.

Legislation: FA 2008, Sch. 36, para. 3

Case: *Taxpayer* [2016] TC 05116

HMRC Manuals: CH24100ff.

In-Depth: ¶186-575

Inspection powers

450 Inspection powers

HMRC have the powers to inspect business premises, business assets and statutory records.

The powers must be used reasonably and proportionately and can only be used to inspect *business* premises, not premises that are used wholly for residential purposes. If they are used only partly for business purposes, then they are partially subject to HMRC's inspection powers.

There are safeguards built into the legislation that are intended to ensure that the use of the powers is reasonable and proportionate. Over and above such safeguards, HMRC must take care not to breach a taxpayer's right to privacy. under the *Human Rights Act* 1998.

Legislation: FA 2008, Sch. 36, Pt. 2, 3, 4

HMRC Manuals: CH25000ff.

In-Depth: ¶186-850ff.

455 Business premises, business assets and business documents – definitions

Business premises are defined in relation to a person as premises that an HMRC officer has reason to believe are used in connection with the carrying on of a business by or on behalf of that person. Premises are given an extended definition to include any means of transport.

Business assets are defined as assets that an HMRC officer has reason to believe are owned, leased or used in connection with the carrying on of business by any person.

Business documents are defined as documents that relate to the carrying on of a business by any person and that form part of any person's statutory records. Statutory records are themselves defined but precisely what forms part of a particular client's statutory records will depend on the client's circumstances. For example, if he is a sole trader or partner, he will need to keep (amongst other things) specified records.

Legislation: FA 2008, Sch. 36, para. 10, 58 and 62; TMA 1970, s. 12B

HMRC Manuals: CH25180, CH25260, CH25280

In-Depth: ¶186-850ff.

If the taxpayer is present, the officer must advise them of their right to ask their agent to be present but need not delay the start of the inspection to await their arrival. Clients should be advised that if an officer makes an unannounced visit, they should ask to see the tribunal's authorisation for the visit. The client does not have to allow access to the premises. Only if the tribunal's authorisation has been obtained will HMRC be able to assess a £300 obstruction penalty (see 475). Otherwise, there is no risk of a penalty and it will be sufficient to agree a more convenient date and time for the officer to call back.

Legislation: FA 2008, Sch. 36, para. 12, 12B, 13

HMRC Manuals: CH25520

Other Material: HMRC factsheets: *Compliance checks: unannounced visits for inspections* - CC/FS4, *Compliance checks: unannounced visits for inspections approved by the tribunal* - CC/FS5

In-Depth: ¶186-850ff.

475 Visits authorised by tribunal

A penalty can be imposed on a taxpayer who obstructs a visit that has been approved by the tribunal. The initial penalty is a fixed £300 and there can additionally be daily penalties of up to £60 for each day on which the obstruction continues. There is no right of appeal against a tribunal authorised visit.

At the same time as seeking the tribunal's approval for the inspection visit, the officer will probably also seek approval for a taxpayer notice to make the records available at the premises. By obtaining the tribunal's approval, the officer ensures that no appeal can be made against any requirements in the information notice.

Legislation: FA 2008, Sch. 36, para. 39, 40

HMRC Manuals: CH26240

Other Material: *Compliance checks: unannounced visits for inspections approved by the tribunal* - CC/FS5

In-Depth: ¶186-850ff.

480 Private residences

HMRC do not have the power to inspect premises that are used *wholly* as a private residence but they can do so if invited to do so by the taxpayer. If the premises are used partly for business and partly as a private residence, HMRC can only inspect the parts used for the business.

HMRC's departmental instructions advise officers, 'Wherever practicable you should avoid inspecting at premises that are also a person's home. You will normally be able to find an alternative location such as at an agent's premises or an HMRC office'. Practitioners may wish to remind officers of this if the advice is overlooked.

It is the view of HMRC that they can inspect a private residence if:

- the business is run from the home;
- business assets are stored at the home;
- business records are kept at the home;
- the business accounts include a claim for 'use of home as office'; or
- a home is registered as the principal place of business for VAT.

HMRC accept that storing records at home because there is nowhere else to keep them is not sufficient to allow them to inspect the private residence unless invited to do so.

Example

A dental surgery is run from the dentist's home. The officer can inspect the offices and waiting rooms and any consulting rooms that are not in use. The inspection cannot be extended into any areas that are used solely as a private residence.

Legislation: FA 2008, Sch. 36, para. 10(2)

HMRC Manuals:CH25220, CH25240

In-Depth: ¶186-850ff.

485 Record-keeping obligations

Practitioners can help to strengthen their clients' position in the event of an enquiry or a business records inspection by advising on the maintenance of adequate business records. This advice will also ensure that clients are not penalised for failing to comply with the record-keeping obligations.

HMRC have published a range of factsheets and online tools to help businesses understand their record-keeping obligations.

Further commentary on record-keeping obligations is included in the consideration of tax returns and record keeping (see 975).

Legislation: TMA 1970, s. 12B(5)

HMRC Manuals: CH10000

Other Material: GOV.UK *Keeping your pay and tax records*

In-Depth: ¶181-900

490 The visit itself

At the start (or in advance) of the visit, the officer will give the taxpayer a copy of a factsheet on visits and explain what will happen during the visit. The officer may indicate that they would like to discuss the records with the person who keeps them. They can only do this with the agreement of the taxpayer.

The taxpayer has the right to refuse to allow the officer to enter the premises. However, unless the taxpayer agrees to a visit at a later date, the officer will consider asking the tribunal for approval for the inspection. If the tribunal has approved the inspection, the taxpayer can be penalised for obstructing the visit unless there is a reasonable excuse such as illness. The penalty for obstructing an inspection that has been approved by the tribunal is a fixed £300 plus a daily penalty of up to £60.

There is no statutory definition of what inspection involves. Some guidance on the point is included in HMRC's *Compliance Handbook*.

The officer should not mark the records that are inspected in any way, even to indicate that they have been checked. Goods or assets can, however, be marked to show that they have been inspected, although the officer must not damage them when doing so.

The officer can record the information obtained in the course of the inspection and can take copies of the documents inspected or make extracts from them, if necessary by removing them from the premises. If a written receipt for any documents removed is not offered, the taxpayer can request one.

Documents removed by an officer should not be retained longer than necessary. If any are lost or damaged, the taxpayer is entitled to compensation.

Legislation: FA 2008, Sch. 36, para. 10–17, 39, 40, 50

HMRC Manuals: CH25140, CH25160

Other Material: HMRC factsheet *Compliance checks: visits by agreement or advance notice* - CC/FS3; *Compliance checks: unannounced visits for inspections* - CC/FS4, *Compliance checks: unannounced visits for inspections approved by the tribunal* - CC/FS5

In-Depth: ¶186-850ff.

Other information powers

520 Data gathering powers

In addition to the information powers explained at 380ff. which are commonly used to obtain information in the course of an enquiry, there are other, less commonly used powers. These include the bulk data-gathering powers, which provide a framework of powers for HMRC to obtain third-party data from a range of specified data-holders, subject to appeal, with penalties for non-compliance.

There is an initial penalty of £300 for failure to comply with a data-holder notice and increased daily penalties can be approved and assessed if a data-holder does not comply with a data information notice request. From 15 September 2016, the administration of the increased daily penalty has been clarified and the amount of the maximum daily penalty increased from £60 to £1,000. The tribunal will decide whether an increased daily penalty is allowed, determine the new maximum amount of such a penalty and the date from which it can be applied, although the process for assessing the increased penalty remains with HMRC.

Legislation: FA 2011, Sch. 23; *Data-gathering Powers (Relevant Data) Regulations* 2012 (SI 2012/847)

HMRC Manuals: CH28000ff.

Other Material: HMRC guidance: *How to complete your statutory notice return*

In-Depth: ¶187-197ff.

525 Powers to obtain information about certain tax advantages and publish state aid information

With effect from 15 September 2016, HMRC have the power to collect information on certain state aids for the purpose of complying with EU obligations in relation to state aids granted through tax advantages. HMRC may determine that claims for a tax advantage specified must include (or be accompanied by) such information, presented in such form, as the determination may specify.

The specified tax advantages are:

- enhanced capital allowances (business premises renovation allowances, zero-emission goods vehicle allowances and expenditure on plant and machinery for use in designated assisted areas (enhanced capital allowances for enterprise zones));

- creative tax reliefs (film tax relief, television tax relief, theatre tax relief and orchestra tax relief);
- research and development reliefs (relief for SMEs: cost of research and development incurred by SME and vaccine research relief).

HMRC may also issue an information notice requiring information in respect of specified tax advantages (as follows):

- reduced rate of climate change levy payable in respect of a reduced rate supply (for supplies covered by climate change agreement);
- relief granted to investors in a company under the enterprise investment scheme;
- relief granted to investors in a venture capital trust under the venture capital trust scheme.

HMRC also have the power to publish and disclose information on certain state aids.

Legislation: FA 2016, s. 180, 181, 182 and Sch. 24

In-Depth: ¶187-797ff.

Penalties

530 Tax penalties – overview

Within the context of an enquiry, a liability to penalties can arise in various circumstances. The main provisions relate to:

- incorrect returns and documents (see 550ff.);
- failure to notify liability (see 700ff.); and
- late filing and payment (see 800ff.).

In addition, a penalty can arise in relation to record-keeping obligations (see 985).

The same 'behaviour-based' principles of calculation apply to most taxes. The current rules apply standard percentages of the potential lost revenue to determine the penalty for three distinct categories of behaviour and then provide specific reductions to reflect the extent of disclosure during the enquiry. The former rules left much more discretion to HMRC, although the department tried to work to a standard practice.

As the current provisions only apply from their relevant introduction dates, the former provisions continue to apply up to the cut-off dates. If a client has possibly incurred penalties in relation to years that straddle the

cut-off dates, the practitioner needs to be familiar with the mechanics of calculation under both regimes. As the current penalties focus heavily on the behaviour that caused the under-declaration of tax liability, the penalty loadings can vary between 0% (innocent error) to 100% (deliberate and concealed error with no reduction for disclosure) of the under-declared tax. In situations involving offshore matters, penalties under the current regime can be as high as 200%. Under the former regime, penalty loadings tended to bunch in a narrower and lower banding.

In certain circumstances, the names of 'deliberate defaulters' can be published by HMRC. Lists are published quarterly.

From 1 April 2017, the naming provisions have changed, so that where there is an inaccuracy in a taxpayer's document, or failure to notify which relates to offshore matters or offshore transfers, only full, unprompted disclosures will be outside the scope of the provisions. The provisions are also amended to allow the naming of certain people who have benefited from the inaccuracy or failure.

HMRC will also monitor the tax affairs of people who deliberately get them wrong, known as serious defaulters. These include people who have been charged a penalty because of their deliberate behaviour.

Consultation

The Government has consulted on:

- proposals for new late submission penalties;
- plans to penalise late payment by penalty interest; and
- the idea of a new penalty regime for dealing with inaccuracies.

The latest consultation *Making Tax Digital – sanctions for late submission and late payment* ran from 20 March 2017 to 11 June 2017. The feedback is currently being analysed, but as the proposals were developed with the Making Tax Digital (MTD) for business obligations in mind any response is likely to be impacted by the changed timetable for MTD announced in July 2017 (see 2390).

Legislation: FA 2007, Sch. 24; FA 2008, Sch. 41; FA 2009, s. 94 and Sch. 55, 56

HMRC Manuals: CH60000, CH70000, CH80000, CH150000, CH190000

Other Material: HMRC published details of deliberate tax defaulters; HMRC compliance checks factsheets; Consultations: *HMRC penalties: a discussion document*; *Making Tax Digital: Tax administration*; *Making Tax Digital: sanctions for late submission and late payment*

HMRC have published a video and transcript of a presentation 'Penalties for inaccuracies in documents and returns'. This can be accessed via the GOV.UK website. It should not be regarded as the last word on the subject but it provides a useful summary.

Legislation: FA 2007, Sch. 24

Cases: *Fab Cleaning Management Ltd* [2016] TC 04824; *Atkinson* [2016] TC 05141

Other Material: HMRC factsheet: *Compliance checks: penalties for inaccuracies in returns or documents* - CC/FS7a

In-Depth: ¶184-850

560 Behaviours

Different standard levels of penalty are set for each of three different classes of behaviour. The three identified behaviours are:

- careless action;
- deliberate but not concealed action; and
- deliberate and concealed action.

For commentary on each behaviour, see 570ff.

Legislation: FA 2007, Sch. 24, para. 3

HMRC Manuals: CH81100

In-Depth: ¶184-850

565 Mistake

Where an error results from a genuine mistake despite the taxpayer having taken reasonable care to complete the return correctly, no penalty arises unless there was an unreasonable delay in notifying HMRC once the error had been identified by the taxpayer. The legislation does not specify that no penalty arises in the case of a genuine mistake; it simply specifies what penalties do arise where the taxpayer's action was careless or deliberate.

HMRC's *Compliance Handbook* provides the following illustrations of when an inaccuracy might arise despite reasonable care:

- a reasonably arguable view of situations that is subsequently not upheld;

- an arithmetical or transposition inaccuracy that is not so large either in absolute terms or relative to overall liability, as to produce an obviously odd result or be picked up by a quality check;
- following advice from HMRC that later proves to be wrong, provided that all the details and circumstances were given when the advice was sought;
- acting on advice from a competent adviser which proves to be wrong despite the fact that the adviser was given a full set of accurate facts (see CH84530); and
- accepting and using information from another person where it is not possible to check that the information is accurate and complete.

HMRC also provide specific practical examples.

Legislation: FA 2007, Sch. 24, para. 3

HMRC Manuals: CH81130, CH81131

In-Depth: ¶184-850

570 Careless action

An inaccuracy in a document given to HMRC is careless if the inaccuracy is due to a failure to take reasonable care. Although the range of penalties is defined by reference to the nature of the action, they apply equally where the 'action' involved an omission – for example, the non-disclosure on a tax return of a source of income.

The current regime provides for a maximum statutory penalty of 30% of the revenue lost for understatements due to a failure to take reasonable care. The maximum reduction in the penalty for a disclosure (see 585ff.) that was completely unprompted could reduce this to a statutory minimum penalty of nil. By contrast, the minimum statutory penalty for a prompted disclosure of an understatement due to a failure to take reasonable care is 15% of the revenue lost. These differences in the level of penalty explain why it is so important for the practitioner to advise the client fully concerning the benefits of disclosure.

As a penalty arises where there is a failure to take reasonable care, it is important to establish what constitutes reasonable care. Under the former regime, the equivalent of failure to take reasonable care was 'negligent conduct'. It is generally accepted that the change in terminology has not changed the test.

Partnerships

KEY POINTS

- The existence of a partnership is a question of fact. What is agreed between the parties is not conclusive of its existence; neither is the existence of a partnership agreement (see 62100).
- For taxation purposes, a partnership is a trade or profession carried on by two or more persons jointly (see 62100).
- Under self-assessment income tax is assessed directly on the partners. Partners chargeable to corporation tax are also assessed directly (see 62130).
- A change in the personnel carrying on a partnership business can trigger provisions treating the business as permanently discontinued at the date of the change and a new business as having commenced. Otherwise, where a partner joins or leaves a partnership, the commencement and cessation rules apply to him individually (see 62110).
- Partnership income is apportioned according to the shares current in the tax year. Salaries paid to partners and interest on capital contributed by partners are deducted from the partnership profits before the shares of each partner are ascertained (see 62115).
- Where a partnership involves a company, the general rules for computing income profits and losses are modified (see 62130).
- Transactions between the partnership and an individual partner are subject to transfer pricing rules (see 62125).
- Partnership losses are divided among partners according to their respective shares. However, loss reliefs available to non-active general partners and non-active members of limited liability partnerships are restricted (see 62140).
- Tax in respect of chargeable gains accruing on the disposal of chargeable assets is assessed and charged on the partners separately and partnership dealings are treated as dealings by the partners and not by the firm. The practical application of capital gains tax to partnership transactions is detailed in an important HMRC statement of practice (SP D12) (see 62160ff.).

Partnership income

62100 Partnerships: general

The existence of a partnership is a question of fact. What is agreed between the parties is not conclusive of its existence; neither is the existence of a partnership agreement. For taxation purposes, a partnership is a trade or profession carried on by two or more persons jointly and a limited partnership is a partnership for tax purposes.

There are some differences in law between English and Scottish partnerships. For example, although a partnership is a legal person in Scotland, in England and Wales it is the individual members of a partnership who are trading and not the partnership itself.

However, for taxation purposes provisions generally apply to partnerships in the UK irrespective of their form. Income tax in respect of partners chargeable thereto has historically been assessed jointly in the name of the partnership. Under self-assessment income tax is assessed directly on the partners. Partners chargeable to corporation tax have always been assessed directly (see 62130).

At Budget 2016, proposals to clarify the tax treatment of partnerships were announced and, following consultation, draft legislation was published on 13 September 2017. The measure provides additional clarity over aspects of the taxation of partnerships including:

- how the current rules and reporting operate in particular circumstances where a partnership has partners who are bare trustees for another person or that are partnerships; and
- the allocation and calculation of partnership profit for tax purposes.

The new rules will take effect:

- in relation to the allocation of partnership profits and losses, with effect for accounting periods and periods of account starting after the date of Royal Assent to the Finance (No. 3) Bill 2017;
- changes to give effect to the new return relaxation in respect of overseas partners in investment partnerships will have effect for returns made after the date of Royal Assent to Finance (No. 3) Bill 2017; and
- other changes with effect for 2018–19 returns.

For more information and to view the draft legislation and explanatory notes, see https://www.gov.uk/government/publications/partnership-taxation-proposals-to-clarify-tax-treatment.

Legislation: *Partnership Act* 1890, s. 4(2); ITTOIA 2005, s. 848

Cases: *Morden Rigg & Co and R B Eskrigge & Co v Monks* (1923) 8 TC 450; *Dickenson v Gross (HMIT)* (1927) 11 TC 614

Other Material: Business Brief 30/04, 19 November 2004, 'VAT and partnership "shares"'

In-Depth: ¶286-000

62105 Limited liability partnerships

Where a limited liability partnership (LLP) carries on a trade, profession or other business with a view to profit:

- all the activities of the partnership are treated as carried on in partnership by its members (rather than by the partnership as such);
- anything done by, or in relation to the partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners; and
- the property of the partnership is treated as held by the members as partnership property.

This treatment applies where the LLP is no longer trading with a view to profit and the cessation is temporary. Where there is a permanent cessation, the above treatment applies in the period of winding up provided that the winding up is not for reasons connected with the avoidance of tax, nor is it unreasonably prolonged. However, this treatment ceases on the appointment of a liquidator or, if earlier, the making of a winding up order by the court.

The following changes, which took effect from 6 April 2014, were introduced to prevent tax loss:

- disguising employment relationships through limited liability partnerships; and
- certain arrangements involving allocation of profits and losses among partnership members.

Broadly, the changes affect Limited Liability Partnership (LLP) members who work for LLPs on terms that HMRC view as 'tantamount to employment' (i.e. disguised employment).

The new rules, designed to counter avoidance of tax, only apply to individuals that are members of LLPs, and to fall within the rules they have to satisfy three conditions (A–C) as follows:

Condition A is that there are 'relevant arrangements' in place for the individual to perform services as a member of the LLP. 'Relevant arrangements' means arrangements under which amounts are to be, or may be, payable by the LLP in respect of the individual's performance of services for the partnership in his capacity as a member of the partnership. The condition will be met if it is reasonable to expect that at least 80% of the total amount payable by the LLP in respect of the individual's performance, during the relevant period of services for the partnership in the individual's capacity as a member of the partnership, will be disguised salary.

An amount will be treated as 'disguised salary' if it:

(a) is fixed;

(b) is variable, but is varied without reference to the overall amount of the profits or losses of the LLP; or

(c) is not, in practice, affected by the overall amount of those profits or losses.

In many cases, this will not lead to any difficulties as partners in an LLP will be remunerated by reference to the overall profits available.

Condition B is that the person concerned does not have significant influence over the affairs of the partnership.

Condition C is that the person's partnership capital is less than 25% of the amount of reasonable expected disguised salary for the tax year. In other words, the person concerned has to have at stake capital of at least one quarter of their partnership income to avoid satisfying this test. The partnership capital is determined on 6 April 2014 or at the date of appointment of the partner and then at the beginning of each subsequent tax year or whenever the partnership sharing arrangements change.

If a person satisfies all three conditions above, then that person is taxed as if they were an employee of the partnership, although their wider legal status as a member of the LLP is not changed.

Legislation: ITTOIA 2005, s. 863; FA 2014, s. 74 and Sch. 17

In-Depth: ¶286-210ff.

62110 Membership changes

Under the self-assessment regime as it applies to partnerships (see 62100), a change in the personnel carrying on a partnership business triggers provisions treating the business as permanently discontinued at the date of the change and a new business as having commenced if none of the original partners continues to carry on the business thereafter.

Where a partner joins or leaves a partnership, the commencement and cessation rules apply to him individually. A sole trader who takes on a partner is treated as continuing to trade, and the partner is treated as commencing to trade. Conversely, when a business goes from a partnership to a sole trader, the latter is treated as continuing and the other partner(s) as ceasing. If partners dissolve the partnership but each continues with part of the business, the partnership business ceases and the commencement provisions apply to the businesses run by the ex-partners.

A change in the personal representatives or trustees who carry on a trade is not treated as a discontinuance.

Legislation: ITTOIA 2005, s. 246

Other Material: SP 9/86

In-Depth: ¶286-420ff.

62115 Partners' salaries and interest on capital

In England and Wales (unlike Scotland), a partnership is not a legal entity. Thus, a partnership cannot enter into a contract of employment with an equity partner and such a partner cannot be the employee of the remaining partners – the same person cannot be both master and servant.

If, therefore, an equity partner is, by virtue of the terms of the agreement of partnership, entitled to salary or wages, he is merely entitled to an allocation of profits before the general division among the partners. This compares with some salaried partners who, by the nature of the particular arrangement in point, are more akin to employees.

The tax consequences of the legal position that equity partners' salaries are not deductible in arriving at the net partnership income (or net partnership loss) poses no problem where the adding back of salaries results in the individual interests of both partners in the net income or net loss showing either a surplus or a deficiency.

Example 1

Alex and Ben are in partnership. Alex is the only active partner and receives a salary of £20,000 p.a. as manager. The profits and losses (calculated after deducting Alex's salary) are to be shared equally. Profits of £15,000 are made in the basis year after deducting Alex's salary.

	£	£
Partnership profit (after Alex's salary deducted)		15,000
Add: Alex's salary		20,000
Assessable income		35,000
Allocation of assessment:	£	
Alex: salary	20,000	
plus 50% of balance (£15,000)	7,500	
	27,500	
Ben: 50% of balance (£15,000)	7,500	
Total	35,000	

Example 2

Charlie and David are partners in a firm. The partnership agreement provides for salaries to be paid as follows:

Charlie = £10,000

David = £5,000

Profits or losses remaining after an allowance for the salaries has been made are shared equally between Charlie and David. The firm makes a loss in a tax year of £20,000 after the salaries have been deducted. The tax-allowable loss is restricted to:

	£	£
Partnership loss		(20,000)
Less: Charlie's salary		10,000
David's salary		5,000
		15,000
Tax loss		(5,000)
Allocation of loss:	£	£
Charlie: salary		10,000
Less: 50% of loss of 20,000		(10,000)
		–
David: salary		5,000
Less: 50% of loss of 20,000		(10,000)
Total		(5,000)
		(5,000)

However, it is in cases where the distribution between the partners in accordance with the partnership agreement results in a surplus for one partner and a deficiency for the other that problems arise.

The basic position can be summarised as follows.

- Where, before taking partners' salaries into account, there is a *net partnership income* for tax purposes, the partner whose entitlement (including salary) shows a surplus is taxed on the whole of the net partnership income; no loss for tax purposes is allowable to the other partner.
- Where, before taking partners' salaries into account, there is a *net partnership loss*, the partner whose entitlement (including salary) shows a deficiency is entitled to the whole of the net partnership loss; no amount is assessable to the other partner.

Interest on capital

Interest paid to a partner on capital which he contributes to the partnership is likewise not an allowable expense but rather an allocation of profit. However, a partner who makes, for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to contribute is entitled (in the absence of a contrary agreement) to simple interest at 5% p.a. Such interest constitutes an allowable expense of the partnership and attracts an income tax charge (see 8450ff.).

Legislation: *Partnership Act* 1890, s. 24(3)

Case: *Heastie (HMIT) v Veitch & Co* (1933) 18 TC 305

In-Depth: ¶289-395

62120 Partnership income

Partnership income is apportioned according to the shares current in the tax year even though, before self-assessment, the assessment may be based on profits of an earlier period. Salaries paid to partners and interest on capital contributed by partners are deducted from the partnership profits before the shares of each partner are ascertained (see 62115). Where a partnership involves a company, slightly different rules apply (see 62130).

Other income of a trading partnership is computed as if the partnership were a UK resident individual, and allocated according to sharing ratios in the period covered by the computation. This is achieved by treating such income as if it were profits, gains or losses of a trade or profession. If the other income is untaxed, then, for basis periods purposes, all sources

of untaxed income are pooled and treated as arising from a separate deemed trade.

HMRC have clarified the treatment of partnership income from jointly owned property. Consider two individuals carrying on business in partnership with land-owning and trading activities arranged such that:

- the partnership business comprises both a business trading income source and a property income source: the income from the property income source will be assessable using the basis periods that apply for the business trading income source;
- there are two separate businesses and two separate partnerships, albeit partnerships between the same two individuals: the income from the property source will be assessable on a tax year basis;
- the letting income is not ancillary to the trading partnership source, and the letting activity cannot be described as the carrying on of a business: the income arising is not assessable as partnership income and each share will be assessable as the personal income of the individuals.

A partner cannot assign his income to another person for tax purposes.

Legislation: ITTOIA 2005, s. 851(1)–(2), 854–855

Case: *Hadlee v Commr of Inland Revenue (New Zealand)* [1993] BTC 13

In-Depth: ¶289-895ff.

62125 Transactions between the partnership and individual partners

Transactions between the partnership and an individual partner are subject to transfer pricing rules. The actual sale proceeds or actual purchase price as appropriate may be adjusted so as to prevent the avoidance of UK tax; thus sales at an overvalue or undervalue may be prevented. The provisions may apply where the buyer or seller is a body of persons, including a partnership, and there is common control with the other party – in the case of a partnership control is determined by reference to a right to more than 50% of the assets or income (for details of the anti-avoidance provision).

Transfers of trading stock may fall within the above provisions or may alternatively be subject to further provisions (see 5625).

Assets owned by an individual partner but used in the partnership trade may attract capital allowances on general principles or, in the case of machinery or plant, by statute.

Legislation: CAA 2001, s. 264; ITA 2007, s. 995

In-Depth: ¶288-895ff.

62130 Partnerships with company members

A company may be a member of a partnership, with other companies and/or with one or more individuals. Where a partnership involves a company, the general rules for computing income profits and losses are modified, as set out below.

In the case of partnership trading income, profits ('profits' does not here include chargeable gains) and losses are computed as if the partnership were a UK resident company (except in the case of a corporate partner which is a company resident outside the UK). This is in order to ascertain the corporation tax liability of the company partner. However, although tax is computed applying corporation tax principles (with reference to accounting periods), initially distributions are ignored and no adjustment is made for capital allowances and charges; also, no deduction is made in any accounting period for losses incurred in an earlier accounting period.

A change in the persons carrying on a trade is treated as a transfer of the trade to a different company if a company continues to be a member of the partnership but is not also a company which was a partner before the change. Thus, a transfer of the trade might give rise to balancing charges in relation to capital allowances. A company's share in the profits and losses of any accounting period is calculated according to its entitlement during that period. Corporation tax is charged as if that share was derived from a trade carried on by the company alone in its corresponding accounting period or periods.

In many cases, the corporate member of the partnership will perform few, if any, duties but will nevertheless be allocated a substantial proportion of the profits. HMRC see this as tax avoidance on the basis that profits parked in the company are only charged to corporation tax, in contrast to the much higher rates of income tax and National Insurance contributions applicable to the profits allocated to individual partners. To counter this perceived avoidance, from 6 April 2014 (subject to certain anti-avoidance rules, which came into force on 5 December 2013), HMRC have the legislative facility to allocate the profits of a partnership to the individual members, replacing any allocation to non-individual partners.

Legislation: CTA 2009, s. 77(5), 1262; FA 2014, s. 74 and Sch. 17

Cases: *Ensign Tankers (Leasing) Ltd v Stokes (HMIT)* [1992] BTC 110; *Hamilton & Kinneil (Archerfield Ltd)* [2014] TC 03485

In-Depth: ¶289-015

62135 Partnership retirement annuities

In some cases, agreements to pay partnership annuities to retired partners might constitute 'settlements' and thus be caught by the anti-avoidance provisions discussed at 62305ff. Normally, however, they will not be settlements, having been made for full consideration.

In-Depth: ¶286-660

62140 General partnership losses

As with profits, partnership losses are divided among partners according to their respective shares. For losses generally, see 6200ff.

Briefly, a partner is entitled to loss relief, for his share of the partnership loss, against other income of the same tax year and against any income of the following year (in so far as relief has not already been given) if he is still a partner in the firm.

However, loss relief available to non-active general partners and non-active members of limited liability partnerships are restricted. Broadly, the amount which may be given otherwise than against income consisting of profits arising from the trade only to the extent that:

- the amount given; or
- the aggregate amount,

does not exceed the amount of the individual's contribution to the trade at the end of the tax year in question.

A loss (in so far as relief has not already been given) may be carried forward by the partner and set against his share of the profits of the trade, etc. for subsequent years (see 6205).

Each partner may choose whether he prefers the former ('carry-across') relief or 'carry-forward' relief. The calculation of the two reliefs may vary where partnership profit-sharing ratios are changed because for carry-across relief (where the loss is generally treated as arising in the tax year in which the accounting period ends), the relevant profit-sharing ratio is that existing during *the tax year* in which the accounting period ends. For carry-forward relief, the relevant profit-sharing ratio is that existing during *the accounting period* in which the loss arose.

Upon the death or retirement of a partner, losses which have not been relieved cannot be carried forward. However, the relief described in 6230 (carry-back of terminal losses) may apply in such cases.

Terminal loss relief applies on a permanent discontinuance of a trade, etc. which includes a deemed discontinuance on a change in partners (see 62110). A person who continues to be a partner after the deemed discontinuance is not entitled to terminal loss relief (though he continues to be entitled to carry forward his losses).

Relief for losses in the early years of a trade may be available (see 6225).

Limited recourse or non-repayable loans, or other reimbursable amounts are excluded from being treated for tax purposes as part of the partner's contribution to a trade, thereby preventing that partner from benefiting from loss relief in excess of the actual amounts lost or at risk. The rules apply to individual partners in limited partnerships, limited liability partnerships, partners who spend less than ten hours per week actively carrying on a partnership trade, and any partners who have claimed film-related losses.

Legislation: ITA 2007, s. 110; *Partnerships (Restrictions on Contributions to a Trade) Regulations* 2005 (SI 2005/2017)

In-Depth: ¶290-725ff.

62145 Limited partnership losses

A limited partnership is one in which one or more members have limited liability provided that at least one member has unlimited liability.

When a limited partnership makes a trading loss, the partners are entitled to make a claim for relief from income tax in the same way as a partner in an ordinary partnership (see 62140). The limited partner's share of the loss is restricted to the amount of his capital contribution. Only that amount can be set off against his other income. The restriction applies to both individual and company partners. It applies not only to limited partners in partnerships restricted under the *Limited Partnership Act* 1907 but also to persons participating in other joint venture arrangements where the liability is limited in a similar way by contract, agreement or guarantee or by the laws of other countries. Any balance of a limited partner's share of the partnership loss which cannot be relieved against other income because of this restriction may be carried forward and set against the limited partner's share of any future profits from the partnership.

See 62140 regarding a restriction for loss relief available to non-active members of partnerships.

Legislation: ITA 2007, s. 56, 104, 110

Case: *Reed (HMIT) v Young* [1986] BTC 242

In-Depth: ¶291-025

62150 Personal reliefs: partnerships

Partners may claim 'personal reliefs' (see 5000) according to their respective shares and interests. Any partner's personal reliefs may be set off against the share of tax attributed to him. Any excess of allowances over tax due on his partnership share can be set off against any other income that he might have.

Legislation: ITA 2007, Part 3

In-Depth: ¶286-885ff.

62155 European Economic Interest Groupings (EEIGs)

The tax regime for European Economic Interest Groupings (EEIGs) broadly provides that:

- any trade or profession carried on by an EEIG is treated as carried on in partnership by the members of the grouping (any member's share of UK trading operations of a group managed and controlled abroad being chargeable in the same way as a non-resident trading in the UK); and
- disposals of assets by an EEIG are treated for tax purposes as disposals by members of the grouping of their shares of the assets concerned,

and income tax or corporation tax, as the case may be, is then charged if appropriate on the profits and gains attributed to the separate members of the grouping.

Legislation: ITA 2007, s. 842 and Sch. 1

In-Depth: ¶772-200

Partnership gains

62160 Introduction to partnership gains

Tax in respect of chargeable gains accruing on the disposal of chargeable assets is assessed and charged on the partners separately and partnership dealings are treated as dealings by the partners and not by the firm.

The practical application of CGT to partnership transactions is detailed in an important HMRC statement of practice (SP D12). The latest version of SP D12 was published on 14 September 2015. The following paragraphs outline the main points of that practice statement. However, the acquisition or disposal of an asset is deemed to be for a consideration

equal to market value where the transaction is not made at arm's length (see 14600ff.) and a transaction is not at arm's length if it is made between connected persons (see 14650ff.), for which purpose a person is, inter alia, connected with:

- any person with whom he is in partnership (i.e. existing partners);
- the spouse or relative of any individual with whom he is in partnership.

Excepted from this definition of 'connected persons' is any acquisition or disposal of assets made pursuant to a bona fide commercial arrangement. In cases where the exception applies, market value is not substituted for actual consideration. However, strictly speaking, the exception does not apply where parties to the transaction are connected persons for reasons other than partnership, e.g. father and son.

Legislation: TCGA 1992, s. 286(4)

Other Material: SP D12

In-Depth: ¶286-495

62165 Partnership assets

Chargeable gains accruing on the disposal of partnership assets are assessed separately on individual partners. Each partner is regarded as owning a share of the partnership assets. The size of that share is usually determined by the partnership agreement specifying the respective shares in asset surpluses. Where the agreement does not so specify, each partner's share will depend on the treatment of asset surpluses in the accounts. Where any surplus is not allocated among the partners, regard is had to the ordinary profit-sharing ratio.

Example

Annie, Bella and Chloe are partners. The profit-sharing ratios are 2:2:1 respectively. The partnership agreement does not deal with the division of surpluses arising from the disposal of assets. The partnership sells certain assets making a gain of £25,000. This surplus is not allocated among the partners but put into a common reserve. The gain apportioned to Annie and Bella is £10,000 each. £5,000 is apportioned to Chloe.

Expenditure on acquiring an asset is allocated similarly at the time of the acquisition.

Other Material: SP D12

In-Depth: ¶286-540

62170 Partnership assets received in kind

A partner receiving a partnership asset in kind is not regarded as disposing of his share in it. The asset is taken by the partner at its market value reduced by any gain attributed to his share. This will be his acquisition cost which he carries forward. Any gains attributed to the other partners are subject to CGT. The same principles apply where a loss results from the disposal.

Example

Alex, Brandon and Callum are partners, each having a one-third fractional share in asset surpluses. Alex and Brandon plan to retire soon and Callum agrees to take a heavier burden in the partnership business. The partnership premises, with a current market value of £50,000, are transferred to Callum. The premises were purchased for £44,000. At the time of distribution, a chargeable gain of £2,000 arises to each of Alex and Brandon. Callum is not regarded as making a chargeable gain. Instead, his base value for CGT purposes is reduced from £50,000 to £48,000 (i.e. by the gain attributed to him).

If, instead of a gain, there had been an overall loss of, say, £6,000, C's share (£2,000) would have been added to the current market value to give a carry-forward value of £52,000.

Other Material: SP D12

In-Depth: ¶286-555

62175 Changes in partnership-sharing ratios and CGT

A change in partnership-sharing ratios (including changes to sharing ratios made when a partner joins or leaves the firm) in general, gives rise to loss a potential charge to capital gains tax, subject to possible rollover relief.

A partner increasing their share of the profits is treated as having made an acquisition of a corresponding share of each asset owned by the partnership. A partner reducing their share is deemed to have disposed of a corresponding share of each of those assets. The cost of the part disposed of is calculated on a fractional basis.

Example

Alice, Brenda, Christine and David are partners in a firm. Share ratios in asset surpluses are 3:1:1:1. The firm takes Emily on as a new partner. Emily is given a one-sixth share and Alice's share is reduced similarly. The current balance sheet value of the principal asset is £90,000, since the asset has not been revalued in the accounts since acquisition.

Alice is treated as disposing of a one-sixth share in the asset for consideration equivalent to base cost of £15,000 (a no gain/no loss disposal). £15,000 also becomes Emily's acquisition cost and the base cost of Alice's remaining interest is reduced to £30,000.

There are certain qualifications to this position, and these are dealt with at 62180 and 62185.

Other Material: SP D12; SP 1/89

In-Depth: ¶286-570

62180 Partnership accounting adjustments and CGT

In the case of partnership accounting adjustments, upward revaluations alone are not occasions of charge and, therefore, do not give rise to chargeable gains. However, if there is a subsequent reduction in a partner's sharing ratio, he is regarded as disposing of a fractional share of the partnership asset (i.e. the fractional difference between his old and new share). The deemed consideration is that fraction of the current book value. The partner with the increased share has a similarly increased acquisition cost to carry forward. The same principles apply to a downward revaluation.

Example

Alan, Brian, Charles and Daniel are partners in a firm. Each is entitled to a quarter share in capital profits from the disposal of Blackacre. Blackacre was acquired for £100,000 in January 1994 and is revalued in the partnership accounts from £100,000 to £240,000 in September 2004. Following the revaluation, the share ratios are altered in January 2015 when Alan becomes entitled to a half share and Brian, Charles and Daniel have their shares reduced to one-sixth each.

There is no chargeable gain at the time of revaluation; but a gain arises to each of Brian, Charles and Daniel on the alteration of ratios. Each is treated as having disposed of a one-twelfth share (i.e. 1/4 – 1/6) for a consideration of £20,000 (£240,000 × 1/12). Alan is regarded as acquiring a quarter share in Blackacre for a consideration of £60,000. Alan's acquisition cost carried forward is £85,000 (i.e. £60,000 + £25,000 attributable to his original one-quarter share). Brian, Charles and Daniel have each made a gain of £11,667.

	£
Proceeds	20,000
Cost (£100,000 × 1/12)	(8,333)
Gain	11,667

In-Depth: ¶286-615

62185 Payments by partners outside accounts for CGT

Payments made outside the partnership accounts upon the change of partnership sharing ratios are included as part of the consideration for the disposal of a partner's share. For example, such payments may be for goodwill not included in the balance sheet, in which case the partner receiving the consideration will have no acquisition cost to set off against his CGT liability (unless he himself made a payment for the share he is now disposing of). However, if the payment is clearly payment for a share in assets which are included in the balance sheet, the partner receiving it will be able to deduct the amount of the acquisition cost relative to that share.

Other Material: SP D12

In-Depth: ¶286-630

62190 Transfers between partners not at arm's length

Changes in partnership sharing ratios do not in themselves normally give rise to chargeable gains or allowable losses (see 62175) unless payments are made outside the accounts (see 62185). However, there is a charge to tax when the transactions are not between persons at arm's length. Market value is substituted for any deemed or actual consideration for the disposal (see 14600ff.).

The transaction is not at arm's length if the parties are 'connected' (see 14650). Often transactions between existing partners will be bona fide commercial transactions and the market value rule will not apply. But market value is substituted where the partners are connected other than by partnership (e.g. father and son).

Market value is not substituted if nothing would have been paid if the parties had been at arm's length or if the sum paid would have been paid if the parties had been at arm's length.

Other Material: SP D12

In-Depth: ¶286-645

Trusts and settlements

KEY POINTS

- The concept of a trust is a matter of general law. It is an obligation imposed on trustees to hold and deal with property transferred to them for the benefit of the beneficiaries or for charitable purposes. The trustees are then treated as separate person for the purposes of tax legislation (see 62200).
- Trusts that are resident in the UK (see 62210) are chargeable to income tax in accordance with the rules applicable to the particular source of income (see 62205).
- Increased rates of tax (the 'trust rate' and 'dividend trust rate') are charged on trust income that is either accumulated or is payable at the discretion of the trustees (subject to relief for the first £1,000 of income) – see 62245.
- The gross equivalent of the income received from a settlement is taxed on discretionary beneficiaries in the year in which it is received, and on beneficiaries with an interest in possession in the year it arises (see 62265).
- Special rules apply to settlements with vulnerable beneficiaries (see 62295) and there are anti-avoidance rules applicable for settlements in which the settlor has an interest or for settlements on children (see 62305).
- If the trustees of a settlement are UK resident, they are subject to CGT on disposal of worldwide assets (see 62385).
- A chargeable gain arises where either the trustees dispose of an asset (by sale or transfer to a beneficiary) or where they are deemed to dispose of an asset (because a beneficiary becomes absolutely entitled (see 62390ff.)
- Anti-avoidance rules may apply to the beneficiaries of non-resident trusts (see 62220) and to the settlors of such trusts (see 62225) and there are special rules where a UK-resident trust ceases to be UK resident (see 62235).
- For IHT purposes a distinction is made between trusts with a qualifying interest in possession (see 62470), trusts with no such interest (see 62505) and special trusts such as charitable or employee trusts (see 62570).
- Trusts with a qualifying interest in possession are now limited to those created before 22 March 2006 and certain special trusts, such as trusts for the disabled. The beneficiary is treated as if he were entitled to the underlying property so a charge arises if either he alienates the property or dies (see 62490).

- Trusts without a qualifying interest in possession are subject to a ten-year anniversary charge (see 62515) and to an exit charge where property leaves the trust (62535)
- Special trusts benefit from a favourable IHT regime (see 62570ff.).

Trusts: taxation and legal background

62200 Operation of trusts

The question 'what is a trust?' is a matter of general trust law. Briefly, a 'trust' is an obligation imposed on trustees (who may be individuals or corporate bodies) to hold and deal with property, that has been transferred to them, in particular ways (which will usually be specified in a trust deed) for the benefit of specified persons, or a class of beneficiaries or, if charitable, for particular purposes. The person providing the trust property (the settlor) may be among the beneficiaries; however, in most circumstances, having the settlor as a beneficiary will result in severe taxation disadvantages.

A 'settlement' is, basically, a trust which creates successive interests in trust property. Such interests may be of income or capital, as between those with a life interest or remaindermen. Normally, life interests have a right to income but not capital whereas a remainderman has the absolute right to receive the capital of the trust to use as they think fit. There may not be a life interest or other interest in possession, e.g. a discretionary trust.

From 6 April 2006, 'settled property' is defined as any property held in trust other than property held as nominee, bare trustee for a person absolutely entitled, an infant or disabled person. References in the legislation to a settlement are construed as references to settled property and the meaning of settlement is determined by case law. This measure aligns what is treated as a settlement for the general purposes of income tax and tax on chargeable gains (see also 62310 for further commentary on the definitions of settlor and settlement contained in *Finance Act* 2006).

Trustees are liable to income tax on the income of the trust on an annual basis as the income is receivable (as with other taxable persons) so are generally required to complete a tax return.

Some trusts, where an interest in possession exists and all the trust income is directly paid to the beneficiary, technically known as mandating the income, will not have to return the same income on the trust return because the beneficiary includes the income on his return; however only the trust can return transactions liable to CGT.

Where income is actually received by the trustees and then paid to a beneficiary, the trustees have to provide a certificate, a form R185, to the beneficiary which allows them to complete their own return. Where the trust is interest in possession, the R185 will show income subject only to the basic rates of tax (2014–15 to 2017–18 – 20% for savings or other income or 7.5% for dividends for 2016–17 onwards, 10% previously) which matches the tax paid by the trustees.

If the trust is discretionary, the income distributed carries a 45% tax credit (2013–14 to 2017–18) whereas the underlying income suffers tax at 38.1% on dividends (2016–17 onwards) (2013–14 to 2014–15 – 37.5%) and 45% on everything else so there is the possibility of a mismatch between the tax certified on income distributions and the tax paid by the trustees; if that occurs, the trustees will have to pay any shortfall between the tax paid and the tax certified to HMRC.

Different formats of R185 are available on HMRC's website for the different types of trust and estate income.

For the incidence of CGT on trusts and settlements, see 62365ff. For the incidence of inheritance tax on trusts and settlements, see 62430ff.

There were proposals from the European Commission for a public register of trusts open to public scrutiny, that would have included disclosure of the trust assets, disclosure of the trust deed and other documents including the letter of wishes but as at February 2016 that possibility is not currently being pursued although there remain some in Europe who would wish that it were so. Company information is in the public domain, with new legislation to increase company disclosure as to beneficial ownership in respect of persons with significant control (PSC) registers where every company must have in place an appropriate register by 30 June 2016 and update it on an annual basis but where a trust owns a company disclosure will only extend to the name of the trust, not the underlying beneficiaries.

Guidance was published on the Department for Business, Innovation and Skills website on 15 February 2016 and should be required reading for all who are involved in managing trusts. The guidance contains the following:

> 'If an individual has significant influence or control over the activities of a trust or firm, which would be a PSC of the company if it were an individual, then you should enter that person's details on the PSC register. If a registrable relevant legal entity (RLE) controls the trust or firm then its details must be entered on the PSC register. If a legal entity which is not an RLE controls the trust or firm, then you should continue to explore the ownership chain until you have identified an individual or registrable RLE with majority ownership of that legal entity, or are confident none exists. [...] If someone other than the trustees, such as the settlor or beneficiary of the trust, or partners has the right to exercise significant influence or control over the trust or firm, then they would also be shown on the register [...].'

With effect from 26 June 2017, additional disclosure requirements have also been imposed on trustees for money laundering purposes.

Reasons for creating a trust

Since time immemorial trusts have often been formed to avoid some unpleasant consequence, and non-tax reasons must not be forgotten; indeed, in many cases, the non-tax purposes will be the primary driver. Often trusts are created because an individual wants to save tax, by giving some assets away, but is uncertain as to the persons who should receive those assets, or knows who they want to benefit but are uncertain if that individual is currently sufficiently mature to look after the assets properly.

In modern marriages, there is often concern with children from a previous marriage that if assets are left to a surviving spouse absolutely that in due course they will not do the right thing and only benefit their own family. This could result in assets being diverted away from the children of the deceased; a trust can achieve the appropriate result. Using a trust allows both flexibility and certainty as to whom or when the assets are transferred absolutely. Trusts and tax planning have a long history; in medieval times, they were used to avoid feudal dues.

These days, there are many reasons for establishing a trust over property, including mitigation of tax. For example, a trust may be set up to save income tax. A settlor, whose income is taxed at the higher rate, could transfer the income-producing capital to trustees. They would hold it for beneficiaries taxed at lower rates or who could then offset their personal allowances or other reliefs against income received from the trust.

Currently, the main tax reason for creating many trusts is to pass property on during the lifetime of the settlor to trustees for beneficiaries to reduce the burden of inheritance tax on death. Trusts preserve maximum flexibility over the ultimate destination of the property. By making a gift into trust (whether during lifetime or by will), the settlor can achieve these objectives as well as securing the inheritance tax advantages that would apply to an outright gift. However, as a result of the *Finance Act* 2006 changes, almost all trusts established on or after 22 March 2006 will suffer an IHT charge at commencement, as well as ten yearly periodic charges, if the taxable value of assets transferred into trust exceeds the available balance of the settlor's nil rate band.

The usual IHT rules apply to assets transferred into trust. Agricultural Property Relief (APR) and Business Property Relief (BPR) will reduce the taxable value transferred but the IHT position will only be confirmed once the settlor has survived seven years.

Example

Lee transfers shares in Lee Trading Limited worth £350,000 into trust but because the shares are eligible for BPR the taxable value is nil.

Example

Laura transfers farmland worth £500,000 into trust; again the taxable value is nil because the farmland is eligible for APR.

Where the assets to be transferred into trust are non-business, then before 22 March 2006, the potential settlor had to use a discretionary trust because then that was the only type of trust that allowed CGT holdover relief on non-business assets. Following the *Finance Act* 2006 changes, CGT holdover relief is now available on transfers of non-business assets into most types of trust. This is because almost all transfers into trust are now potentially chargeable to IHT on establishment; the fact that the taxable value is nil, as in the Lee and Laura examples above, or the transferred value is less than the settlor's nil rate band does not make any difference (transferable nil rate band does not count for this purpose as it is only available on death). Holdover relief under TCGA 1992, s. 260 is available on transfers into most types of trust on or after 22 March 2006.

This means that a potential settlor of non-business assets can now choose the type of trust that best suits their planning objectives rather than being forced to use a discretionary trust.

Trusts are frequently set up for purposes other than tax mitigation and may be used:

- to hold property for those who cannot manage their affairs, such as minors or mentally incapacitated persons;
- to hold property for persons in succession as when property is left to A for life thereafter to B;
- to protect spendthrifts from themselves (a very Victorian concept);
- to preserve maximum flexibility in the event of unforeseeable circumstances. The discretionary trust is the ideal vehicle to achieve this objective;
- to benefit charity.

In some cases, trusts represent a convenient legal regime for certain activities (e.g. pension funds and unit trusts). In other cases, trusts may be imposed by law. This happens when, for example, a person dies intestate and property passes to minors under the intestacy law.

How to create a trust

A trust may be established by a settlor during lifetime ('inter vivos') or by will, or it may arise automatically if someone dies intestate (i.e. without making a will).

An inter vivos trust may be oral (exceptionally rare but often a recipe for confusion) but it is eminently desirable to set out all the necessary provisions in a formal deed. Indeed, if the trust property comprises land, it is generally the case that the trust must be evidenced in writing. A will must be in writing and satisfy certain other formalities as to execution unless made by a person on active service in the armed forces, or a mariner or seaman at sea.

The creation of trusts by deed or will is generally the province of lawyers and advice must be taken.

In particular, it is essential that the trust document should set out in full everything that is required. Once it is executed, a trust may not be altered unless the trustees have been given powers of variation. This is unlike a contract where the parties are free to agree to subsequent changes. A will can always be changed at any time before death provided the necessary formalities as to execution are observed. Even after death, a deed of variation, formally a deed of family arrangement, may be effective for capital gains tax and inheritance tax but not income tax if the variation is from a parent to the benefit of their minor children where the income remains taxed on the parent even though the capital has been moved on.

The *Trustee Act* 1925 and *Trusts of Land and Appointment of Trustees Act* 1996 apply, unless and except to the extent that the trust instrument provides to the contrary. These Acts contain a number of useful automatic provisions. The trust document does not need to set out these provisions specifically unless variations are to be made. Other Acts and case law provide a general framework but considerable thought must be given to the contents of the document. For example, it is usual to provide very wide powers of investment. Unless this was done, trustees could otherwise invest only in investments authorised by the *Trustee Investments Act* 1961. These investment powers have been extended by the *Trustee Act* 2000 so that, for example, trustees may proceed with an investment without taking advice where they judge this a reasonable course of action.

In setting up a trust, there must be what are commonly called three certainties:

(1) the certainty of words;

(2) the certainty of subject matter; and

(3) the certainty of objects of the trust.

If the trust fails in these certainties, it will not be effective under trust law and, as a result, may not achieve the desired tax savings.

Trust documentation

Since 6 April 1991, HMRC do not ask for a copy of trust documents. Instead, they rely on information shown by trustees, settlors and beneficiaries in their annual tax returns or repayment claims. When a new trust is created, trustees must register the trust online and provide information on the beneficial owners of the trust. This procedure replaces the requirement to complete the (paper) form 41G (Trust) that was withdrawn at the end of April 2017. Registration must be made by 5 October of the year after a liability to income tax or CGT first arises. In subsequent years, the trustees (or their agent) are required to provide beneficial ownership information, using the online service, by 31 January after the end of the tax year.

If neither income nor gains immediately arise, there is no need to advise HMRC of the establishment of the trust until income or gains arise when the obligation would then be to tell HMRC by 5 October following the end of the tax year in which a taxable event occurred. This change does not alter the examination of deeds for inheritance tax purposes by the Capital Taxes Offices.

HMRC will seek further information only where necessary, and only exceptionally will they ask to see trust deeds, wills or other documents. That may happen if, for example, there are queries with a tax return or repayment claim, or if the taxpayer is unsure of the effect of the document and the issue cannot be resolved in some other way. Part of the usual self-assessment process.

Trust provisions

Beneficial interests

Analysis and classification of the particular type of beneficial interest is essential for tax purposes. This is discussed in more detail in the sections dealing with each tax.

When a trust is set up, the tax consequences of the precise beneficial interests created must be borne in mind.

(1) Income or capital: a beneficiary may only have an interest in income. A life interest is usually a right to receive income for life or for a set period although it can extend to use of assets, such as occupation of a property, during the lifetime of the beneficiary. An annuity might be given. This is a right to receive specified periodical payments for a specified period that could be for life. A beneficiary may only have an

interest in capital. This would be where, for example, property is left to A for life and thereafter to B. B has an interest in the trust capital but can only take that capital when A dies.

(2) In possession or in remainder or reversion: this is where property is held on trust for A for life and then for B. A has an 'interest in possession' which has been described as a present right of enjoyment. B has an 'interest in remainder' which is deferred until after A's death. This is sometimes called a 'reversionary interest'. B would be known as a 'remainderman' or 'reversioner'.

(3) Vested or contingent: where property is held on trust for A for life, the remainder to such of the children of A as attain the age of 21, A has a vested interest. A does not need to satisfy any conditions to be entitled to it: A's children have contingent interests. Each child's interest will only become vested if and when they reach 21 years of age.

(4) Determinable and defeasible: if property is held on trust for A (a widow) until she remarries, A's interest is determinable because she is only entitled to enjoy it until she remarries. An interest is defeasible if, though vested, it can subsequently be lost. This would be the case if, for example, property is held for the children of A if they attain 18. If no child reaches 18, the trust would fail because there would be no certainty of objects. This is why many trust deeds leave the funds to a charity if all else fails. The charity has a vested interest but one which will be defeated if any child of A attains 18. Its interest will be in possession if in the meanwhile it is entitled to the income ('the intermediate income') but in remainder if the income goes to A's children. Often, the vested interest of a beneficiary is defeasible because the trustees have a power of appointment enabling them to pay income or capital to another beneficiary.

(5) Mere *spes*: a beneficiary under a discretionary trust has a mere *spes* (a Latin word meaning hope). Unless and until the trustees decide to pay something, income or capital, the beneficiary is entitled to nothing. Trustees of such a trust therefore enjoy enormous flexibility. They can usually accumulate income for the period permitted by law and are not bound to know who has a vested interest in capital until the end of the maximum period permitted by law. They are also usually given wide powers to change the nature of the trust, particularly the beneficial interests, and an absolute discretion over who amongst the class of beneficiaries may receive income and capital and in what shares although the exercise of discretion must be exercised in a reasonable manner.

Trusts and powers

A *trust* is mandatory. If the trustees fail in their duty, the courts will enforce it at the request of any beneficiary. A *power* is discretionary. Trustees may choose whether or not to exercise a power and if they decide not to, the courts will not compel them to do so.

It is often important to determine whether a provision is a *trust* or a *power*. A trust to distribute income with a power to accumulate means that income must be paid out unless all the trustees agree to accumulate it. A trust to accumulate income with power to distribute it means that one trustee can insist income be accumulated. There must be unanimity between the trustees. The distinction between a trust to sell with a power to retain, and a power of sale in relation to trust property, is similar, but the importance of a trust for sale has declined following the *Trusts of Land and Appointment of Trustees Act* 1996.

Trustees, particularly of discretionary trusts, are often given powers of appointment. These are powers to alter the beneficial interests in income and capital by taking these away from one beneficiary, or class, and giving them to another. Such powers may permit the creation of new trusts, sub-trusts, alterations to the size of particular shares, and distributions to other trusts, even foreign trusts.

Accumulations and perpetuity

The rules concerning accumulations and perpetuity had long been the subject of debate and were reformed by the *Perpetuities and Accumulations Act* 2009 which came into effect 6 April 2010. However, the main change is to the law relating to perpetuities; in general, the rules against excessive accumulations for charities remains unchanged at 21 years because accumulation would affect a charity's primary purpose of assisting the community.

The current rules apply to documents executed on or after 6 April 2010 but there is provision for pre-6 April 2010 trusts to opt into the current regime. For trusts operating under the old rules, the law did not permit trust income to be accumulated indefinitely (whether under a trust or power). It laid down six maximum periods, the most common of which was the period of 21 years from the date of the deed for a lifetime settlement or from the date of death for a will trust.

In addition, income could be accumulated during the minority of any minor beneficiary.

Once the permitted accumulation period had expired, the income must be distributed.

The property comprised in the trust fund has to become vested in a beneficiary or beneficiaries within the 'perpetuity period', i.e. the maximum period permitted by law. The law's intention is to prevent a settlor from tying up property in trust for generations without any limit. For trusts governed by the pre-6 April 2010 rules, property must vest within the lifetime of a living person plus 21 years, or, if specifically chosen, within a period of up to 80 years, from the date when the settlement commenced. For trusts governed by the post-5 April 2010 rules, the maximum permitted period is 125 years. The settlor must choose the period required. Some trusts, such as charitable trusts and pension funds, are exempt from the perpetuity rule.

If, at the outset, it seems possible that some interests may not vest within the perpetuity period, it is permitted to wait-and-see for a period which is broadly similar to the perpetuity period. If an interest vests within the wait-and-see period, the trusts are valid.

For trusts governed by the *Perpetuities and Accumulations Act* 2009, there is a single period of 125 years during which, if desired income can be accumulated but at the end of that period the assets would have to vest in a beneficiary.

Power of maintenance

Under the *Trustee Act* 1925, trustees have a power to pay or apply income to or for the maintenance, education or benefit of a beneficiary who is an unmarried minor (under the age of 18) but must otherwise accumulate it. It is essential that the gift should 'carry the intermediate income' and that the settlor should not exclude this section of the Act unless similar trusts are set out in the settlement document. Most trusts allow this part of the *Trustee Act* 1925 to be implied, though many vary its terms slightly. They may, for example, enable the trustees to exercise their discretion subjectively, as they may think fit, rather than objectively. Provided the trustees do not act unreasonably, a subjective discretion is less open to challenge than an objective requirement on the basis an objective test will require guidelines which can then either be seen to apply or not.

This section of the *Trustee Act* 1925 (s. 31) should be expressed to apply whether the minor's beneficial interest is vested or contingent. It has two main effects.

(1) During minority, the trustees have discretion to pay the income out for the maintenance, education or benefit of a beneficiary, but otherwise they must accumulate it.

(2) When the minor attains 18, or marries earlier, they must pay income from then on until the beneficiary's interest vests, is defeated or the beneficiary dies. Accumulations of income not paid out during minority will go to the beneficiary if the interest vests on attaining 18 but, if not, they are added to capital. As a result, the accumulations would only pass to the beneficiary if the beneficiary attains a vested interest in capital. Such a vesting of capital would arise, for example, where the beneficiary attains 25 in a trust contingent on attaining 25.

A minor who marries under 18 is treated as ceasing to be a minor at marriage but pre-1970 trusts will have 21 as the relevant age (the then age of majority).

Power of advancement

The *Trustee Act* 1925, s. 32 allows trustees to advance 50% of the prospective share of capital to any beneficiary. Most modern trust documents vary this to 100%. It is a type of special power that is exercisable by a trustee resolution and is read into every trust unless excluded. If a beneficiary's interest is defeated, the advance does not have to be repaid but it is taken into account on final distribution.

Legislation: *Trustee Act* 1925, s. 31, 32; FA 2006, s. 88, 89 and Sch. 12 and 13; *Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations* 2017 (SI 2017/692)

Case: *Sinclair v Lee* [1993] Ch 497

HMRC Manuals: TSEM1004ff., TSEM1400

In-Depth: ¶350-000; ¶354-300

62205 Trustees generally

The provisions of tax legislation frequently refer to 'the person' or 'any person'. 'Person' is defined in the *Interpretation Act* 1978 as including a body of persons. It follows that such provisions are able to cover trustees of a settlement, as well as individuals.

Where a valid trust has been created and trustees receive income from the settled property on trusts, other than bare trusts, the trustees are chargeable to income tax in respect of that income in accordance with the rules applicable to the income. The basis of this is that the trustees either receive or are entitled to this income (and in most cases both receive and are entitled to the income) and hence are, for example, within the charging provisions in respect of:

- trading profits;
- property business profits;
- interest;
- dividend and dividend related income; and
- miscellaneous income.

Trustees are treated as a deemed single person, distinct from the actual persons who are (from time to time) the trustees of the settlement, who are jointly (but not jointly and severally), entitled to the settled property. They are liable to income tax on income arising from the settled property independently of the settlor and the beneficiaries. Where different trust assets are held by different persons, then (unless a sub-fund election is in place) all such persons are treated as one.

If trustees are neither in receipt of the income from the settled property nor entitled to receive it, they are not assessable in respect of it. The most common situation in which this occurs is where trustees authorise a beneficiary with an interest in possession, or his agent, to receive income direct. HMRC have recently clarified the question of what actually constitutes mandated income. Their view is that interest in possession trust income is mandated to the beneficiary when the beneficiary will receive that income directly from the source or, in other words, any scenario where the income does not go via the trustees' bank account but straight to the beneficiaries. Such income is excluded from the Trusts and Estates Tax Return.

A sub-fund election allows part of the trust, which may already be independently administered, to be taxed independently of the trust of which it was previously a part. A sub-fund election should not be made lightly; it triggers a CGT charge on the sub-fund assets (unless holdover under TCGA 1992, s 165 is available) and in addition there is then an additional settlement to be taken into account for the purposes of dividing both the CGT annual exempt amount and the income tax £1,000 standard rate band.

Changes of the individual trustees are ignored. Thus, if a sole trustee carries on a trade within the trust, then his resignation as trustee and the substitution of another individual in his stead does not give rise to a cessation and recommencement of that trade.

Tax may be assessed and charged on and in the name of any one or more of 'the relevant trustees', i.e. the trustees to whom the income arises and any subsequent trustees of the settlement.

Trustees are not 'individuals' and are accordingly not entitled to personal allowances or other reliefs which are only available to individuals; nor are they subject to progressive rates of tax (see, however, 62245 in respect of the 'trust' rates of tax on income which is accumulated or paid at the trustees' discretion) or charges that only apply to individuals such as Class 4 NIC on business profits.

In an interest in possession (IIP) settlement, the trustees are liable to tax at the basic rates on any income received (thus, for 2015–16 and earlier years, 10% on dividends but covered by the non-refundable tax

credit and 20% on everything else). For 2016–17 onwards, interest in possession trustees will pay tax at 7.5% on dividends (the position on income otherwise taxable at 20% is unchanged). Trustees should consider whether they should mandate the income to the beneficiary (who, in any event, is entitled to the income) to avoid having to complete a return. That will then allow the life tenant full use of the £5,000 dividend 0% band with the result that possible repayment claims can be avoided. Many IIP trustees already mandate the income; this change may encourage many more to do so.

The HMRC April 2016 Trusts and Estates Newsletter introduced a concession for trustees for 2016–17 (only) that allows trustees not to have to complete a tax return if the only income received is savings interest where the aggregate gross interest is less than £500 and the tax liability less than £100. Any distribution, would be taxed in the normal way. In reality is this concession of any practical use? Many trusts will receive both dividends and interest so it would seem that trusts in 2016–17 receiving (say) dividends of £100 and savings interest of £300 will have to make a return.

Double taxation agreements

Trustees are regarded as a deemed 'person' and not as individuals. Any provision in a double tax agreement which is applicable to a 'body of persons' is potentially applicable to trustees. It is necessary, therefore, to look at any relevant double taxation agreement to see whether this overrides the domestic law in relation to their tax residence. Where, by application of their domestic laws, the two parties to the agreement would regard the settlement as being resident in both countries for the same year, the agreement will specify which of the two shall be treated as the residence of the trust and relief within the agreement will be available to the trustees against liabilities arising in the other country.

Trustees' management expenses

Because the charge to income tax is on income received by the trustees, the expenses of the trustees in administering the trust are not generally deductible. The measure of the income is in accordance with the normal rules. However, the trust rates charged on discretionary trusts are not charged on that part of the income of such a trust which is used to defray appropriate trust management expenses (see 62255). The trust income that is used to pay the expenses is only liable at the usual basic rates of income tax (see 62245).

Following the *Peter Clay* case, HMRC updated their guidance on trust management expenses; see HMRC *Trusts, Settlements and Estates Manual* at TSEM8000–TSEM8790. In particular, apportionment of expenses between income and capital may be permitted provided the trustees have sufficient information to justify the proposition that the part apportioned to income was incurred solely for income purposes. As with any self-assessment issue, no query arises until HMRC seek justification for the claimed deduction. A blanket 50% claim against income every year is unlikely to be appropriate. In addition, apportionment must follow the basis upon which charges are calculated.

So, for example, stockbroker fees are unlikely to be apportioned because they usually charge a composite fee to cover fund management, both income and capital; the charge will not vary whatever results the stockbroker achieves so cannot be said to be 'wholly and exclusively' for either income or capital purposes.

Income charged on settlor

Income of a settlement is treated as income of the settlor if he or his spouse retains any interest in the trust property or if the income is paid or can be paid, or applied for the benefit of his minor unmarried child. In addition, capital sums paid to the settlor may be treated as his income to the extent that it falls within the amount of income available up to the end of the year of payment. This circumstance would arise if a parent varied a will to redirect their inheritance to a trust for their minor children.

Under current rules, where a parent settles funds for the benefit of their minor children, unless the amount of income received by the trust is below the de minimis limit of £100 per parent per child (ITTOIA 2005, s. 629–632), all income arising on the settlement, where the settlement was made after 9 March 1999 is assessable on the parent who made the settlement. Accordingly, in general, under current rules establishing an income producing settlement for the benefit of minor children is an unattractive proposition.

The position was different for settlements created before 9 March 1999 where, provided the income is not distributed, it is not assessed on the settlor parent; that position continues today for such settlements. If, however, capital is added to a pre-9 March 1999 settlement, then any income that arises on the added capital is then taxable on the settlor parent in exactly the same way as income arising on a settlement created on or after 9 March 1999; even if that income is not paid out.

If the settlement can invest in non-income producing assets, then the parental settlement rules can be avoided. Equally, the charge on parents can be avoided provided the income, as of right, belongs to the child.

Because the child is under 18, it cannot be paid out to them because, until they are 18, they cannot give a valid receipt. However, that means that when the child becomes 18 they have an absolute right to have the income paid out to them. That is likely to raise the traditional concerns that parents and grandparents have about allowing individuals who they still regard as children access to either income or capital at an age where they may not be fully responsible.

Where a tax repayment is available to the settlor, where the income is assessable on him, because his lower rate band and personal allowances are not absorbed by other income, that repayment must be paid to the trustees or the person entitled to the income under the terms of the settlement (see 62250).

Further, the income treated as belonging to the settlor is income before deduction of any trust expenses. Therefore, the R185 issued by the trustees to the settlor should show the income assessable at the rate at which tax was deducted at source, without allowance for expenses not the reduced income that would have been assessable at the special trust rates.

Where income arising in a settlement is treated as the settlor's income, he should complete the Trusts page T1, boxes 7–14 after reviewing the guidance in Helpsheet HS 270.

Trustees acting for incapacitated persons

The trustee, guardian, tutor, etc. of any incapacitated person is in a special position. He is assessable and chargeable to income tax to the extent that the incapacitated person would be charged and assessed. This is so where the trustee, etc. has the direction, control or management of the property of the incapacitated person, whether or not that person resides in the UK.

A special tax regime applies (from 6 April 2004) for certain trusts with vulnerable beneficiaries. Such trusts and beneficiaries can elect into the regime and, where a claim for special tax treatment is made for a tax year, no more tax will be payable in respect of the relevant income and gains of the trust for that year than would be paid had the income and gains accrued directly to the beneficiary.

Income and gains arising from the property held on qualifying trusts for the benefit of a vulnerable person is eligible for the alternative tax treatment. The special treatment does not apply in cases where the settlor is regarded as having an interest in the property from which the qualifying trust income arose.

Broadly, the amount of income tax relief under this regime is the difference between two amounts. The first of those amounts is what (were it not for the special rules) the income tax liability of the trustees would be in respect of the qualifying trusts income for the tax year. The second amount is the amount of tax to which the vulnerable person would be liable if the qualifying trusts income were that person's own income.

For details on the special CGT treatment available, see 62415.

Legislation: FA 1989, s. 151(4); ITA 2007, s. 474

Cases: *Aikin v Macdonald's Trustees* (1894) 3 TC 306; *Williams v Singer* [1921] 1 AC 65; *Reid's Trustees v IR Commrs* (1929) 14 TC 512; *Dawson v IR Commrs* [1989] BTC 200; *Trustees of the Peter Clay Discretionary Trust v R & C Commrs* [2009] BTC 50

HMRC Manuals: TSEM8000–TSEM8790

Other material: TAXguide 13/17 – Trusts and mandated income

In-Depth: ¶350-100

Residence of trustees

62210 Residence of trusts

From 6 April 2007, common rules determine the residence of trustees and trusts. Trustees will together be treated as if they were a single person and the deemed person will be treated as resident (and, for tax years prior to 2013–14, ordinarily resident) in the UK when all of the trustees are resident; or at least one trustee is resident and at least one is not and the settlor is resident or domiciled (or, prior to 2013–14, ordinarily resident) in the UK when the settlement was created.

Under the common rules, a non-resident trust must have all non-resident trustees if it has a UK resident or domiciled settlor. If the settlor is non-resident and non-domiciled, there can be a majority of UK trustees provided that one of them is non-resident. From 6 April 2017, for both income and capital gains tax purposes, F(No. 2)A 2017 applies the extended definition of domicile (the new deemed domicile rules (see 14325)) in determining the settlor's domicile status for these purposes.

Where the relevant residence condition(s) are not satisfied, no tax can be charged even if the assets concerned are located in the UK unless, for disposals on or after 6 April 2015, the asset is a UK residential property interest (see 14340), in which case the trustees are chargeable to capital gains tax in respect of any chargeable NRCGT gain (see 14340) accruing in the tax year (TCGA 1992, s. 14D(1)).

However, because offshore trusts are not otherwise chargeable to capital gains tax, a number of anti-avoidance provisions have been introduced under which:

- gains are attributed to UK resident beneficiaries (see 62220);
- gains are attributed to UK domiciled settlors (see 62225);
- a charge arises on exporting a UK resident settlement (see 62235 and 62240).

Legislation: TCGA 1992, s. 69 and Pt. 3, Ch. 2

HMRC Manuals: TSEM10005

In-Depth: ¶358-025; ¶359-200ff.; ¶591-450

62215 Settlements with foreign element: special returns

HMRC have extensive powers to obtain information in relation to non-resident or dual-resident settlements and the settlor, the trustees and persons who transfer property to the trustees must submit certain information to HMRC if the trust is, or becomes, non-resident; there are exclusions from the requirements to provide information where it has already been supplied as a result of some other provision.

Legislation: TCGA 1992, Sch. 5A

In-Depth: ¶359-525; ¶359-825

62220 Gains of offshore trusts apportioned to beneficiaries

In relation to any settlement where the trustees are not resident (or, for tax years prior to 2013–14, ordinarily resident) in the UK gains (after deduction of losses) accruing to trustees are, within certain limits, attributed to beneficiaries who receive capital payments from the trustees, etc. See 62240 for extension of charge in respect of dual resident settlements.

Capital payment

A capital payment is a transaction not at arm's length representing:

- any payment on which the beneficiary is not liable to pay income tax; or
- any payment received other than as income by a beneficiary who is resident (or, for tax years prior to 2013–14, ordinarily resident) outside the UK,