Briefing

Private client review for March

Speed read

This month, we comment on the recent decision in *Haworth*, which looks at the interpretation of the 'place of effective management' tie-breaker residence test for corporate trustees. When disposing of foreign assets, exchange rate fluctuations may mean that the CGT charge does not reflect the true economic outcome of the transaction, as illustrated by a recent FTT decision. There is success for HMRC in a recent 'mixed property' SDLT case. Updated HMRC guidance on the meaning of 'substantial' may well prove to be a double-edged sword for taxpayers looking to claim BADR. Finally, taxpayers are reminded to take a careful, measured approach to the valuation of gifts of qualifying investments to charity.

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Trustee place of effective management: around the world we go!

The recent decision in *Haworth v HMRC* [2022] UKFTT 34 (TC) provides useful judicial commentary on the correct interpretation of the 'place of effective management' (POEM) tie-breaker test for corporate trustees in the context of a 'round the world' scheme.

The trustees of a family trust held shares in a UK company that was soon to be listed during the peak of the 'dot-com bubble' in 2000. In an attempt to escape UK CGT on the disposal of these shares, a scheme was designed (essentially by UK advisers) to exploit the tie-breaker test under the UK/Mauritius double tax treaty. In very simple terms, this involved the appointment of Mauritian resident trustees who would then resign in favour of UK resident trustees following the sale of the UK shares by the Mauritian predecessors. These steps were all to occur in a single UK tax year, meaning that the trustees were resident both in Mauritius (at the time of sale) and the UK during the same tax year.

Critical to the decision was the correct interpretation of article 4(3) of the treaty, which set out the tie-breaker test for determining the treaty residence of a person liable to tax in both contracting states. Article 4(3) stated that a person 'shall be deemed to be a resident of the contracting state in which its place of effective management is situated.'

In a 164 page (!) judgment, the First-tier Tribunal (FTT) concluded that there was no need to find that the 'central management and control' of the Mauritian trustees at the time of the disposal had been usurped by the UK trustees or the UK advisers. Instead, the POEM test looked at whether there was some overarching scheme of management of the trust that could be divorced from the day-to-day management of the trustee (per *Smallwood v HMRC* [2010] EWCA Civ 778).

Applying this approach, the FTT found that the trust was effectively managed in the UK at the relevant times. In particular, the scheme was 'devised, decided upon, facilitated, orchestrated and superintended in the UK by the settlors and the UK advisers ... on an on-going basis'; it was always intended that the Mauritian trustees would be in office for only a brief period.

The facts of *Haworth* have largely historical significance, these schemes having been counteracted. However, this case illustrates a point of wider application, namely the potential effect that dominant third parties (here, the UK advisers) can have on the residence position of trusts.

Exchange rate fluctuations and CGT: fairness is irrelevant

Whilst the phrase 'sterling ... is the only permissible unit of account' may have a faintly anachronistic ring to it, it remains an accurate statement of the law relating to the calculation of capital gains for UK tax purposes, as illustrated by *Rawlings and another v HMRC* [2022] UKFTT 32 (TC).

In 2006, UK resident taxpayers bought a house in Switzerland with a Swiss franc-denominated mortgage. The house was sold in 2016. In calculating the UK CGT due on the sale, the taxpayers deducted from the sale price (among other things) their mortgage repayments and transaction fees, in each case converted to sterling at the time these costs were incurred, at rates not challenged by HMRC. HMRC, however, disagreed with the calculation method as a whole, asserting that the gain must be calculated by deducting from the sale proceeds the purchase price and associated costs of both transactions, each assessed in sterling. HMRC calculated a gain of over £267,000, nearly seven times the taxpayer's figure. The taxpayers contended that, due to a substantial depreciation in the value of sterling between 2006 and 2016, the inflation (in sterling terms) in the value of their Swiss franc-denominated mortgage should be taken into account; otherwise, HMRC's method would give rise to an absurd charge to tax when the true economics of the transactions were considered.

Although the FTT expressed sympathy for the taxpayers, it concluded that HMRC's calculation method was correct, commenting that 'the legislation is not predicated on a "fair" or even a "reasonable" basis of taxation. Capital gains are calculated in a mechanistic way by reference to actual consideration received and given at its sterling equivalent in respect of assets however the acquisition of those assets are funded'.

In May 2021, the OTS asked the government to consider whether gains or losses on foreign assets should be calculated in the relevant foreign currency and *then* converted into sterling. However, in November 2021, the government confirmed that it does not intend to make this change. UK taxpayers should therefore remain alert to this potential trap and, when disposing of foreign assets, remember that the UK CGT charge may not reflect the true economic outcome of the transaction.

SDLT: continued success for HMRC

The rate at which SDLT is chargeable on the purchase of UK land depends on various factors, including whether

the land in question consists of residential property. Where the purchase involves 'mixed property', i.e. there are both residential and non-residential elements, the whole purchase is subject to SDLT at the lower non-residential rates (even where only a small proportion of the property is non-residential in nature). It is therefore to the taxpayer's benefit if they can identify a non-residential aspect to their property purchase.

Last month, the Court of Appeal issued its judgment in *Hyman and others v HMRC* [2022] EWCA Civ 185, in which property purchases, each comprising a house and an area of land, were examined. FA 2003 s 116 defines residential property for SDLT purposes as including 'land that is or forms part of the garden or grounds' of a dwelling. Relying on a 2003 statement of practice relating to stamp duty, the taxpayers argued that, for garden or grounds to count as residential property for the purposes of s 116, they must be needed for the 'reasonable enjoyment' of the dwelling having regard to its size and nature. Given the extensive grounds associated with the properties in question, their view was that these were 'mixed property' purchases to which the lower non-residential SDLT rates would apply.

In dismissing the taxpayers' appeal, the court noted in particular Lord Hodge's recent statement, in the Supreme Court's judgment in *R (on the application of O) v Secretary of State for the Home Department* [2022] UKSC 3, that 'external aids to interpretation must ... play a secondary role' in statutory interpretation and do not 'displace the meanings conveyed by the words of a statute that ... are clear and unambiguous and which do not produce absurdity'. The court considered that 'the words of section 116 are clear and unambiguous' and that the taxpayers were attempting to 'imply into an Act of Parliament a limitation which is not there'.

As noted in our February column (*Tax Journal*, 18 February 2022), the government has published a consultation on SDLT, citing concern that 'the current rules are leading to potentially unfair outcomes ... or abuse of the rules'. In the context of mixed property transactions, it suggests introducing either an apportionment basis (taxing the residential portion at residential rates and the non-residential portion at non-residential rates) or a threshold test (treating the purchase as mixed property only if the non-residential element is more than a certain proportion of the consideration). The consultation closed on 22 February, so we await news of possible reform. In the meantime, taxpayers should exercise caution when considering whether their purchase constitutes a mixed property transaction and remember that HMRC guidance is no substitute for applying the statute itself.

Subtle changes to BADR guidance: a double-edged sword?

To qualify for BADR, or not to qualify for BADR, that was one of the questions addressed in *Allam v HMRC* [2021] UKUT 291 (TCC), mentioned in our January 2022 column. In that case, considering entrepreneurs' relief (the precursor to business asset disposal relief – BADR), the UT found that it was not appropriate to apply any numerical threshold (as HMRC's guidance did at the time) in determining whether activities are, to a substantial extent, trading activities. The UT endorsed the FTT's view that in this context substantial should be 'taken to mean material or real importance in the context of the activities of the company as a whole'.

Following *Allam,* HMRC updated its guidance in the *Capital Gains Manual* last month. Previously, the guidance stated that 'substantial in this context means more than 20%', so one considered whether more than 20% of the company's income or assets, or of the expenses incurred or time spent by officers or employees, were attributable to non-trading activity.

The new wording in CG64090 provides: 'For practical purposes it is likely that from accounts submitted some consideration can be given to the level of non-trading income and the asset base of the company. Where neither of these suggest the non-trading element exceeds 20% the case is unlikely to warrant any more detailed review.'

Whilst this more flexible wording might simply be aimed at reflecting the latest case law, it could be a double-edged sword for taxpayers looking to claim BADR. The flexibility could be to the taxpayer's advantage or detriment, potentially resulting in more disputes.

Recent data from HM Treasury shows CGT receipts increasing by a whopping 20% to a record £12.9bn in the year ending 31 January 2022. Part of this increase will be due to the reduction of the BADR lifetime limit from £10m to £1m in the 2020 Budget, along with rumours of the end of the relief, which accelerated disposals. Whether this increase in CGT receipts might now tempt the government to trim BADR even further is a question for another day; at this stage the government has simply said that it is keeping the tax system under constant review.

Valuation of shares gifted to charity: an art, not a science

Tax reliefs on charitable donations play an important role in incentivising people to provide support to the charity sector. Gifts of 'qualifying investments' (e.g. listed shares) offer two forms of relief for the donor: (i) the donation is treated as being made on a 'no gain no loss' basis for CGT purposes, and (ii) the donor's taxable income in the year of the donation is reduced by the value of the qualifying investments.

The market value of a gift of AIM-listed shares to charity, at the date of the gift, was the sole point of contention in *Dwan and others v HMRC* [2022] UKFTT 36 (TC). In that case, both parties provided expert evidence. The taxpayers' expert sought to base his valuation solely on a small number of trades on AIM. In his view, investors in a small parcel of shares would rely only on publicly available information and would not undertake any other type of valuation, verification or cross-check. In contrast, HMRC's expert approached the matter in 'microscopic detail, supported by hundreds of pages of exhibits'. In her view, a prudent prospective purchaser would make appropriate enquiries and take into account various factors, including a lower value given to the company in other documents, projected revenue, and the performance of other similar companies. Given her 'measured and careful' approach, the FTT preferred and accepted the valuation given by HMRC's expert, resulting in a higher tax bill for the taxpayers due to their excessive valuation of the shares gifted to charity.

This case is a cautionary tale for those claiming tax reliefs based on share valuations. The FTT noted that share valuation is an art, not a science. A number of avoidance schemes have sought to exploit qualifying investment relief, sparking scrutiny from the government. Charities are encouraged to inform HMRC if there are any discrepancies between the apparent value and the amount that the charity is able to realise from gifted shares. Whilst this case was not an avoidance case, HMRC may nonetheless be encouraged by the outcome and challenge more share valuations in the context of gifts to charities, to protect this relief for 'genuine' donors. ■