Current state of play

Zahra Kanani charts recent developments in tax policy

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The purpose of this article is to provide an update to some of the key points raised in Smith and Williamson's Tax Update dated 16 February 2009, to see how these have been addressed by early 2011. In particular, this article concentrates on the new system of tax tribunals introduced in 2009, the extension of agricultural property relief to the European Economic Area (the EEA) and the recent amendments to the excepted estate regulations.

Tax Tribunal update

As part of a wider programme of tribunal reform taken forward by the Ministry of Justice, the Tribunal, Courts and Enforcement Act 2007 created a new tribunal system. It put in place a framework for a two-tier system, comprising a First-tier Tribunal and an Upper Tribunal, with specialist chambers handling particular types of appeal.

The new system was created under the Transfer of Tribunal Functions and Revenue and Customs Appeals Order 2009 (SI 2009 No 56) (the Order), which came into force on 1 April 2009.

First-tier Tribunal

The First-tier Tribunal is organised into 'chambers'. The Tax Chamber hears tax and national insurance contributions appeals. In most cases it is the tribunal of first instance, with some of the Special Commissioners and VAT and Duties Tribunal members presiding over some appeals. As well as a right of appeal from the First-tier Tribunal to the Upper Tribunal, the First-tier Tribunal also has power to review its decisions. Costs are generally not available in the First-tier Tribunal.

Upper Tribunal

The Upper Tribunal is a single tribunal and is also organised into 'chambers'. The Tax and Chancery Chamber hears tax and national insurance contributions cases. Judges who used to preside over High Court appeals comprise the Upper Tribunal, alongside some of the previous Special Commissioners and VAT and Duties Tribunal members.

The purpose of the Upper Tribunal is to replace the old right of appeal to the High Court. Appeals from the First-tier Tribunal go to the Upper Tribunal, with leave. Appeals that raise a point of law of wider importance, are of particular complexity or those involving large sums of money may, in certain cases, start in the Upper Tribunal. Costs are available in cases heard in the Upper Tribunal.

Since 1 September 2009 judicial reviews of HMRC's tax functions have been heard by the Tax and Chancery Chamber.

Brief overview of the procedural rules for the new tax tribunals

Each set of rules (for the First-tier Tribunal and the Upper Tribunal) are governed by an overriding objective to enable the tribunals to deal with cases 'fairly and justly.' The rules also introduce the requirement for the tribunals to bring to the parties' attention the availability of alternative dispute resolution.

The Tax Chamber of the First-tier Tribunal has a unique four category system with four tracks: default paper, basic, standard and complex.

Briefly, the default paper category is for simple appeals (such as late filing penalties for small amounts) that are dealt with purely on written submissions unless either party requests a hearing. Cases of a particular type (for example all standard tax penalties other than those dealt with in the default paper category, appeals against information notices, applications for permission to make a late appeal, etc) are allocated to the basic track and are then dealt with at a hearing, with minimal exchange of documents before the hearing. Standard cases will usually be subject to more detailed case management and be disposed of after a hearing. A case can only be allocated to the complex track if the tribunal considers that it will require lengthy or complex evidence or a lengthy hearing; involves a complex/important principle or issue; or involves a large financial sum. Complex cases are subject to a special costs regime and may also be transferred to the Upper Tribunal.

The Tax and Chancery Chamber of the Upper Tribunal hears appeals from the Tax Chamber of the First-tier Tribunal, cases transferred from the Tax Chamber of the First-tier Tribunal, and carries out judicial reviews of the tax functions of HMRC. Overall, the procedural rules for the Upper Tribunal are largely similar to those for the First-tier Tribunal.

Appeals from the Upper Tribunal

Any party wishing to appeal the decision of the Upper Tribunal has to apply to the Upper Tribunal for leave to appeal to the Court of Appeal within one month of receiving the written reasons for the decision. If the Upper Tribunal refuses leave to appeal, leave may be sought from the Court of Appeal. Permission to appeal to the Court of Appeal will only be granted where the Upper Tribunal (or where the Upper Tribunal refuses permission, the Court of Appeal) considers that either of the following conditions is satisfied: the proposed appeal would raise some important points of principle or practice, or if there is some other compelling reason for the Court of Appeal to hear the appeal.

HMRC's internal review process

Since 1 April 2009 there is a new two-stage process for lodging tax appeals, with taxpayers having the option of requesting an impartial internal review by HMRC of a disputed decision, before, or as an alternative to, an appeal to the tribunal.

A taxpayer wishing to dispute a decision of HMRC must first give notice to HMRC. It is possible to give notice of appeal out of time, but only with the consent of HMRC or the consent of the tax tribunal.

The taxpayer can then either:

- Notify the appeal to the tax tribunal.
- Request HMRC to carry out an internal review of the disputed decision.
- Do nothing. HMRC may offer an internal review and it is up to the taxpayer whether to accept the offer of internal review or notify the appeal to the tax tribunal. If the taxpayer does neither of these things, the matter is settled in accordance with HMRC's view of the matter.

If an internal review is carried out and HMRC gives notice of its conclusions within 45 days, the dispute will be deemed to be settled under s54 Taxes Management Act 1970.

Effect of an HMRC internal review

If an internal review is carried out and HMRC gives notice of its conclusions within 45 days, the dispute will be deemed to be settled under s54 Taxes Management Act 1970 (TMA 1970) in line with HMRC's conclusions under the review, unless the taxpayer gives notice of appeal to the tax tribunal within 30 days of the notice of the result of the review. The taxpayer is not able to repudiate or resile from the settlement under s54(2) TMA 1970.

If HMRC does not give its conclusions under the review within 45 days (or any other agreed period), its original view will be treated as upheld. HMRC must then notify the taxpayer of the conclusion that the review is treated as having reached. The taxpayer has the choice of accepting the decision, in which case the dispute will be deemed to have been settled under s54 TMA 1970 in line with the conclusion that HMRC is treated as having reached, or appealing to the tax tribunal. Again, the taxpayer is not able to repudiate or resile from the settlement under s54(2) TMA 1970.

The taxpayer can give notice of appeal to the tax tribunal at any time between the end of the 45 days (or other agreed period) and 30 days after receiving details under section 49E(9) TMA 1970, or later with leave of the tax tribunal.

IHT: Agricultural Property Relief

In an announcement made on 29 January 2009, the European Commission formally asked the United Kingdom to amend its legislation, which provided for 'discriminatory inheritance tax relief'. The requests took the form of reasoned opinions (the second step of the infringement procedure of Article 226 of the EC Treaty), with the Commission stating that the UK should allow inheritance tax relief for all agricultural and forestry property situated in other EU and EEA member states as it does for similar property in the UK, Channel Islands and the Isle of Man. The Commission was concerned that the 'limited scope of IHT relief in this regard would dissuade taxpayers from investing in agricultural and forestry property outside the UK.' Consequently, the Commission considered that the UK's legislation was not compatible with the free movement of capital as provided by Article 56 of the EC Treaty and Article 40 of the EEA Agreement. The UK was given two months within which to respond, failing which, the Commission in its discretion could refer the case to the European Court of Justice.

On 9 February 2009, HMRC published revised guidance on agricultural property relief (APR), which is now chapter 24 of the Inheritance Tax Manual. In the 2009 Budget, the government addressed the Commission's concern by announcing that APR would be extended to property within the EEA. This was enacted in Finance Act 2009, which amended s115(5) of the Inheritance Tax Act 1984 (IHTA 1984). It was also announced that property qualifying for APR would qualify for hold-over relief for capital gains tax purposes.

Making a repayment claim for inheritance tax (IHT) already paid

The extension of APR came into effect on 22 April 2009. At the time, it applied to IHT due, or paid, on, or after, 23 April 2003. In order to receive a repayment, the deceased's personal representatives (or an individual in respect of a lifetime chargeable transfer) must make claim for repayment to HMRC by the later of either the last date that such a claim can be made under s241(1) IHTA 1984 or 21 April 2010. On receipt of a claim, HMRC would repay the overpaid tax together with interest. Since 21 April 2010 has now passed, claims must be made within the time limit under s241(1) IHTA 1984, ie within six years of the payment, or the last payment of IHT that was made.

Effect of extending APR to the EEA

The amendments made to s115(3) and the new s116(8) create what some commentators refer to as a 'fiction' that relevant laws of the UK have effect in the states of the EEA. The difficulties identified relate to the superimposition of the rules on foreign jurisdictions.

In order for a claim to be made for APR in relation to property situated in the EEA, it is necessary for the deceased to have died while domiciled, or deemed domiciled, in the UK (or for an individual to be domiciled in the UK at the time of making a lifetime chargeable transfer). Where the requisite conditions are met and APR relief applies, it will have the effect of ensuring that no UK IHT is payable in relation to the agricultural value of the property, in the same way as though the property were in the UK.

Difficulties in respect of the extension of APR to the EEA

One problematic area that has been identified is in relation to tenanted properties as it is entirely conceivable that there might be difficulties over what constitutes a valid tenancy. No real attention has been paid to adjusting the relief to take into account the varying forms of land ownership and tenancies that may be encountered in different EEA states.

Another problem may arise when agricultural property is purported to be held on behalf of a beneficiary in an EEA state that does not recognise the existence of such a beneficial interest. It is unclear what the position would be in relation to APR. It is possible that s116(8) IHTA 1984 could be interpreted to ensure that from a UK perspective any purported beneficial interest over an EEA property would be a valid beneficial interest. However, this would be difficult especially where a person who does not have a recognised, valid interest in an EEA property could claim they had a valid beneficial interest for the purposes of UK IHT.

It has been argued that the 'character appropriate' test, laid down in *Lloyds TSB Private Banking plc v IRC (No 1)* [2002] in relation to farmhouses, may raise potential difficulties. In this case, a substantial residence was held to be a farmhouse of a character appropriate to the property due to a number of factors, including its use and visual presentation as well as the existence of farm buildings. Applying the character appropriate test to the EEA may be difficult due to the diverse nature of activities undertaken that may be considered as 'agricultural' in states outside the UK, Channel Islands and the Isle of Man (for example vineyards).

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Amendments to the excepted estate regulations

What is an excepted estate?

If the estate of a deceased person falls within the criteria for an 'excepted estate', the personal representatives can submit a reduced inheritance tax account. There are broadly three categories of excepted estate as set out in the Inheritance Tax (Delivery of Accounts) (Excepted Estates) Regulations 2004 (SI 2004/2543) (the 2004 Regulations):

- low-value estates where the gross value of the estate and lifetime chargeable transfers does not exceed the nil rate band;
- 'exempt estates' where the gross value of the estate and lifetime chargeable transfers (if any) does not exceed £1 million and, after the deduction of liabilities, any part of the estate exceeding the nil rate band is exempt as it passes to a spouse (references to 'spouses' also include 'civil partners') or a registered UK charity; and
- estates of individuals who have never been domiciled, or deemed domiciled, in the UK, and where the UK estate consists solely of cash and quoted stocks and shares not exceeding £150,000 in value.

Between September and November 2010, HMRC ran a consultation on further amendments to the 2004 Regulations and published draft amending regulations. The proposals centred around widening the categories of excepted estates, relating to low-value estates and exempt estates, so that estates in which there is a transferable nil rate band may qualify as excepted estates.

In the consultation document, HMRC also proposed that the value of the chargeable transfer, deemed to be made on death, would include transfers qualifying for exemption as normal expenditure out of income. The transfers must exceed £3,000 in any tax year. The consultation proposed that these transfers be taken into account in determining whether an estate qualifies as an excepted estate in the same way as the value of agricultural or business property qualifying for relief is currently included.

Transferable nil rate band

The transferable nil rate band was introduced by Finance Act 2008. Where an individual dies on, or after, 9 October 2007, that individual's personal representatives can claim any unused percentage of the nil rate band of a spouse who died before the individual. These provisions are found in ss8A to 8C of the Inheritance Tax Act 1984. Broadly speaking, in practice, this means that the nil rate band of the surviving spouse can be doubled (under current figures to £650,000), but no more, even if the survivor has more than one spouse. It is worth noting that in this year's budget, the chancellor announced that the nil rate band would remain frozen at £325,000 until April 2015.

Summary of changes and consultation responses

Five professional bodies and three practitioners responded to HMRC's consultation. The proposals were widely supported as removing burdens in relation to the most straightforward of estates. The general proposition was that if the estate has no tax liabilities following the transfer of the nil rate band then it should be treated as an excepted estate with a suitable calculation being included on the excepted estate form.

In light of the consultation, regulations amending the 2004 Regulations, The Inheritance Tax (Delivery of Accounts) (Excepted Estates) (Amendments) Regulations 2011 (SI 2011/214) and an Explanatory Memorandum were laid before the House of Commons on 3 February 2011 and came into force on 1 March 2011.

IHT threshold

The definition of 'IHT threshold' has been extended to take into account the transfer of the nil rate band between spouses. It is important to note that this only applies where none of the nil rate band available against a first spouse's estate has been used. HMRC rejected the view of some respondents that the new regulations should provide for an increase in the inheritance tax threshold where only part of the first spouse's nil rate band had been used. HMRC were of the opinion that the added complexity would have benefitted only a small number of estates and increase the risk of errors being made. These amendments will have effect for deaths on or after 6 April 2010. This means that together with the excepted estate form, a claim to transfer any unused nil rate band is also submitted. A new claim form IHT217 has been introduced for this purpose. Two responses received had suggested that the claim for the transfer of any unused nil rate band be included within the excepted estate form itself. HMRC did not take this suggestion forward as it considered that the majority of those using the excepted estate form will have no requirement to make a claim.

It should be noted that there is a time restriction of two years in which to make a claim under s8B of the Inheritance Tax Act 1984. Any claim that is made outside this time period can only be admitted at the discretion of HMRC. Therefore, where a claim is made out of time, a full IHT account must be delivered.

Normal expenditure out of income

In relation to deaths on or after 1 March 2011, use of the 'normal expenditure out of income' exemption will need to be taken into consideration when considering eligibility as a low-value excepted estate or an exempt excepted estate when the total amount exceeds £3,000 in any tax year in the seven years prior to the death. Broadly, where there is no nil rate band to transfer, the value transferred by the gifts, which are considered exempt, is to be added to the chargeable and gross value figures of the estate. Where there is a transfer of nil rate band, the excepted estate process cannot be used (in relation to the second spouse to die), if the first spouse died on or after 1 March 2011, and the value of exempt transfers by the first spouse exceed the £3,000 level. However, any transfers over the £3,000 level by the second spouse to die will not in itself deny use of the excepted estate process; the transfers are added instead to the chargeable and gross value figures.

In order for a claim to be made for APR in relation to property situated in the EEA, it is necessary for the deceased to have died while domiciled, or deemed domiciled, in the UK.

It should be noted, however, that where the enhanced gross and chargeable value figures exceed the limits contained in the regulations (which remain unchanged, for example £1 million or £150,000 as appropriate), the estate will fail to qualify as an excepted estate.

HMRC have also made it clear that in respect of the criteria for 'exempt excepted estates', at least part of the estate must pass to their spouse or a charity.

The amendment to the rules to take into account the transferable nil rate band is uncontroversial, although more restrictive than it could have been. The amendment to disregard the exemption for normal expenditure out of income reflects HMRC's general concern about what it considers to be the 'inappropriate' use of this exemption particularly for lifetime transfers into trusts. It remains to be seen whether the new system will speed up the process of obtaining probate or create a further administrative burden. ■

Lloyds TSB Private Banking plc v IRC (No 1) [2002] WTLR 1435