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A Newsletter for Fellow Professionals from Hillier Hopkins LLP
Autumn 2008

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Solicitors Accounts Rules – Common pitfalls and fraud

A few points to ponder:

Rule 19: Receipt and transfer of costs states that where a solicitor properly requires payment of his fees from money held in a client account they must first give or send a bill of costs. The emphasis here is on 'properly', i.e. the work has actually been done and the solicitor is entitled to the appropriate money for costs.

Once the bill has been sent the money earmarked for costs becomes office money and must be transferred within 14 days. For the avoidance of doubt, the money is earmarked by the solicitor not the client and, unless otherwise expressly indicated, money will be deemed earmarked.

Rule 23: Requires proper authority for withdrawal from client account. It is important to note that electronic signatures are not sufficient under the present rules. When electronic or telephone transfers are made there must be a specific authority signed in accordance with the rule before the instructions are given. A pre printed form is recommended.

Secret profits

Be aware: The making of secret profits is a criminal offence under the Fraud Act 2006.

Client money is at risk from solicitors who take secret profits, no matter how small such profits may be. When

solicitors charge for disbursements they can recover only what they have paid out for the client. However, some solicitors add a mark-up, for instance on telegraphic transfer fees and searches, but still describe the full figure as a disbursement.

Another way to take a secret profit is to charge clients for a disbursement paid to a company, such as one providing searches, and receive a small payment in return from the company for each search ordered. The solicitor retains the 'commission' on the basis that it is less than £20 but this is not a genuine commission arrangement and is an improper way for a solicitor to take clients' money indirectly.

Various other arrangements are to be found in practice, often of a larger nature, where the client is not told of money that belongs to them and which is kept by the solicitor.

The Fraud Act 2006 criminalises the taking of secret profits. A solicitor who "dishonestly fails to disclose to another person information which he is under a legal duty to disclose" with a view to making a gain will be guilty of fraud, because solicitors are required to tell clients about money they receive when acting for them.

If you would like further information please contact Cathy Leach on 01442 220788 or email solicitors@hhllp.co.uk

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Discounted Gift Trusts (DGTs)

Discounted Gift Trusts have been with us for several years and many readers will be familiar with them. They are useful for clients who:

1) Wish to undertake some intelligent tax planning, or

2) Are nervous of outright gifts because they enjoy the income they receive from their capital.

Essentially the concept is that a client places (that is, gifts) a sum of capital into a trust for various beneficiaries. If the client survives for seven years from the establishment of the trust the money is entirely outside of the estate for inheritance tax purposes. However, the client also retains a right to a series of payments from the capital (not income) of the trust for the rest of the client's lifetime. Many clients think of this as "income" though in fact it is capital. These payments are usually fixed and defined at outset.

If a client passes away during the initial seven year period the value of the gift is generally established on "the loss to the estate" principle. Since the client retained a right to payments of capital the loss to the estate is not the entire capital sum but is reduced by the capital value of these retained or carved out rights. Therefore if the client dies unexpectedly the day after establishing one of these schemes there is an immediate reduction (discount) in the estate compared to having not entered into the arrangement.

The gift is normally invested in an offshore life assurance or capital redemption contract. This allows the gift to grow gross of nearly all taxes and conveniently produces no income for HMRC purposes.

These arrangements have been well established for many years. Hillier Hopkins LLP has had many clients enter into such arrangements. The only point of contention with HMRC that we have been involved in is the quantum of the discount mentioned in the paragraph above - we have never had any correspondence about the efficacy of the basic arrangement.

There have been some recent changes which might be of interest:-

The new trust regime

The Finance Act 2006 introduced a new regime for trusts. In most cases payments into trusts above the nil rate band trigger an immediate liability to 20% tax on the excess over and above the nil rate band. Where the client has made previous gifts these may also need to be taken into account. DGTs were often established using trusts that will now be caught by this 20% charge. (Where matters are straightforward and the amount is below the nil rate band discretionary trusts are a simple solution). DGTs are often established for amounts much larger than the nil rate band.

The tax planners therefore designed a DGT using a bare trust. The bare trust is patently less flexible than a discretionary trust. Beneficiaries and proportions are decided at outset and cannot be varied. They have however proved attractive to clients, particularly those with adult settled children. The ability to get, for example, £1,000,000 outside of the estate after seven years, retain a right to income-like payments of £50,000 per annum (which trigger no immediate liability to tax) and to achieve an immediate inheritance tax saving, can be an appealing proposition.

For those considering gifting just a little more than the current nil rate band a discretionary trust may still be worth considering. We would argue that the value of the gift for determining any IHT liability is the discounted figure, not the absolute cheque payment.

Calculating the discount

The value of the discount represents the value of the anticipated flow of capital payments back to the settlor. Where the settlor is old or very ill this anticipated flow is small and so the discount is small. There is also a time value of money discount rate to consider. In May 2007 HMRC published new guidance on their website regarding how to quantify the discount. This is of course only relevant for deaths in the first seven years. They published detailed guidance on how discounts would be calculated. They have since updated this guidance to reflect changes in interest rates. This is, by and large, a welcome development that will help reduce tedious correspondence. The publication of this guidance is also surely tacit agreement that the discount exists.

Those over 90??

HMRC have for many years argued that where a client enters into a DGT at the age of 90 or above (or are considered actuarially and medically to have the life expectance of a 90 year old or older) then no discount exists. Reams have been written on this and the vast bulk of practitioners that I have spoken to roundly dispute the idea that at age 90 the discount vanishes. The nub of the issue is of course valuing the flow of payments back to the donor. HMRC argue that no investor would enter into a contract to buy this stream of quasi-income payments therefore it is valueless.

A case has now gone to the Special Commissioners (SPC00665). In February 2008 the Special Commissioner decided broadly in favour of the taxpayer. Hurrah – we all breathed a sigh of relief.

In April HMRC announced that they are appealing the decision.

Conclusion

Discounted Gift Trusts remain an extremely useful tool in the adviser's armoury. Tax deferred growth, tax deferred quasi income payments, outside of the estate after seven years and an immediate discount on day 1. Take care with those over 90, or with unusually low life expectancy.

For more information please contact Ben Sherwood on 01442 220788 or email solicitors@hhllp.co.uk

Capital gains tax changes

Now the dust has settled it seems appropriate to review the changes that have taken place to the capital gains tax (CGT) regime over the last 12 months. From 6 April 2008 the rate of CGT is reduced for individuals, personal representatives and trustees to 18%. This compares with a previous rate of 40%. However, with the benefit of taper relief and indexation (now abolished) the rate of CGT could have been 10% or even lower. In some ways this has brought enormous simplification to the calculation process. However, it also produced an outcry from the family business community who saw their tax liabilities increased from 10% to 18%.

The new Entrepreneurs' Relief (ER - limited to maximum lifetime gains of £1m) goes some way towards addressing their concerns although there are severe restrictions. For trustees relief will only be given for the disposal of shares held in a company, which is the qualifying beneficiary's personal company in which he or she must be an officer or an employee. In order to meet the personal company definition, the beneficiary must own 5% of the shares and voting rights personally in addition to any shares that are held by the trustees. This is a much more onerous test than the previous test for business assets taper relief. ER may also be given for other business assets held by trustees. If relief can be claimed than the gain is reduced by 5/9 to give an effective tax rate of 10%.

There are many traps for individuals who may be unaware that a radical rethink is needed before assuming that the relief will be available on business assets. No longer will it be irrelevant if rent is charged by an individual on a property, which is let to the family business. Any such arrangement will invalidate a claim for ER. Claims can be made where all or part of a business has ceased and for assets which were used in a business which has ceased within the last three years. However, the sale of assets without the sale of the business or the cessation of trade will not qualify for relief. It might also be the case that a business will not qualify because a significant proportion of the assets are not used in the business.

Prudent business owners would do well to ask their professional adviser to review respective claims for ER as a result of the substantial legislative changes.

Individuals may still be unable to understand how HMRC are going to interpret the new targeted anti-avoidance rules (TAAR) for CGT introduced 12 months ago. The intention is that they are to stop individuals deliberately and knowingly entering into arrangements to gain a tax advantage where there is no genuine economic loss. However, one can envisage a situation where husband is holding shares showing profits whilst wife is holding other shares showing losses. Between them there is no economic loss. If wife transfers her shares to husband who then sells all the shares he will have obtained a tax benefit because his own gain will have been reduced by the loss on the shares from his wife. The legislation appears to catch this transaction although the examples given in the HMRC Guidance notes are less clear. It may well be that unsuspecting spouses carrying out what they perceived to be straightforward tax planning could be caught.

The calculation may have been simplified but there still remains much to debate.

For more information please contact David Nye on 01442 220788 or email solicitors@hhllp.co.uk

This newsletter is for general guidance only and no liability is accepted for action taken in reliance upon these notes where appropriate professional advice should be taken. For more information please contact us on: 01442 220788 or email solicitors@hhllp.co.uk