However, the Special Commissioners in *Transco* decided that the work had not changed the character of their pipeline system. In each of the years under review, under 1 per cent of the whole pipeline was replaced with polythene and in any event Transco had no plans to replace the whole system; replacement only occurred when necessary for safety reasons. Furthermore, the expenditure was not connected in any way to the change to natural gas and there had been no change in the pressure. Accordingly, the expenditure incurred by Transco was revenue and not capital expenditure. It was also relevant that there was no significant prolongation of the networks' useful life by this replacement policy, there was no increase in capacity or improvement in quality or any increase in the open market value of the fixed assets. The established principles of commercial accountancy pointed to the conclusion that the expenditure was properly charged to revenue.

Contributed by Peter Vaines, Haarmann Hemmelrath

Inheritance Tax

131. Lease carve-out schemes

It was suggested at item 106 of TAXline June 2002 that the lease carve-out scheme immortalised by the *Ingram* case could still be used if a landowner is prepared to take a 14 year view and have at least a seven year period elapse between the grant of the lease and the gift of the reversion, the latter being a potentially exempt transfer which he would hope to survive by at least seven years so as to make it exempt.

A possible problem might arise in the form of the FA 1999 amendments to the reservation of benefits regime. In particular, section 102A(5), FA 1986 provides that a 'right' or 'interest' is not 'significant' if it was granted or acquired before the period of seven years ending with the date of the gift. However, the same let-out is not provided in relation to a 'significant arrangement'. Accordingly, in appropriate circumstances, the Inland Revenue might argue that the grant of the lease and the gift of the reversion seven years and one day later was such a preordained arrangement and that therefore continuing occupation of the land following the gift does constitute a reservation of benefit.

Arguably the easiest way out of the conundrum, provided that the clients do not want to adopt some other tax mitigation arrangement, is (subject to availability of cash or other value) to have a sale for full market value of the freehold reversion following the grant of the lease. The terms of the lease can be so arranged as to minimise the value of the reversion (thereby perhaps also mitigating any stamp duty burden).

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132. Reversionary lease schemes

The reversionary lease scheme has proved to be a popular alternative to the lease carve-out scheme referred to above in tax planning for the family home. A lease is granted at no rent for, say, 999 years which arises after a given period of years. The initial gift of the lease is a transfer of value, but the value transferred will normally be small, and in any case is often a potentially exempt transfer. The freeholder in the meantime retains the freehold which, due to the lease, is much depreciated on the freeholder's death.

Peter Twiddy (director of litigation at the CTO) acknowledges that such schemes, if set up before 9 March 1999, work. In a similar manner to lease carve-out schemes, whether or not such schemes will continue to work where they are set up on or after 9 March 1999 depends on the interpretation of the words 'a significant arrangement' under new section 102A(2), FA 1986. If the grant of a deferred reversionary lease can be regarded as constituting a significant arrangement then it will be treated as a gift with reservation even where the grantor has owned the interest for at least seven years. This is likely to be the view taken by the CTO. The counter argument is that the grantor continues to occupy the property by means of his original interest so that the gift with reservation rules do not apply. The CTO will no doubt seek to test the validity of their view in due course.

Excerpt from a seminar on trusts introduced by Jane Blades BSc CA FTII of the Mercia Group LLP at the recent TaxAid Personal Tax Update conference.

133. Agricultural and business property reliefs

It is important to remember that, although agricultural property relief (APR) and business property relief (BPR) are deceptively similar, they are quite independent reliefs and operate in different ways. In particular APR can be available to agricultural landlords, whereas under section 105(3), IHTA 1984 let property of itself constitutes a disqualifying business for the purposes of BPR.

The landlord and tenant case of *Jewell v McGowan and others*, heard in the Court of Appeal on 18 February 2002, shows that a narrow construction is to be given to the meaning of 'agriculture'. A similar issue arises where a landowner grants a farm business tenancy which, following seven years' ownership, retains his right to 100 per cent relief and during the seven year period before he dies the tenant breaches the provisions of the agreement and carries on non-agricultural activities. A claim for breach of contract for the consequential loss of very valuable agricultural property relief is unlikely to succeed. The moral of the story is that activities of tenants do need to be very carefully monitored.

From the May 2002 Tax Planning Bulletin of McKie & Co LLP, written by Sharon Anstey and Simon McKie.

134. Agricultural value

When considering tax planning it is often overlooked that Agricultural Property Relief (APR) is restricted to the agricultural value. So how is the agricultural value defined? It is defined by section 115(3) IHTA 1984 as *The value which would be the value of the property if the property was subject to a perpetual covenant prohibiting its use otherwise than as agricultural property.*

Priority is given to APR under section 116(1) IHTA 1984 over BPR as when property qualifies for both reliefs APR is given first.

The first point that any tax planner would worry about (as indeed would their clients) is the fact that the market value of agricultural property might well exceed its agricultural value and therefore could be a differential which would be chargeable to inheritance tax over and above the APR claim. It is at this point that we look at the scope of the claim for business property relief (BPR) as it is hoped that BPR could be claimed against the difference.

Differences in value could be caused by such practice as sporting rights which would have a considerable influence on the value of agricultural land. As the raising of pheasants is not deemed to be (in most instances) for the purpose of the production of food then this would not qualify as agricultural and a business relief claim would be looked at. In these instances as with any form of diversification it will be important to examine just exactly how the shoot is run and how it is managed as a business. Thus, the landowner might not secure APR on the value of the sporting rights but it could well be that BPR would be claimed on the business element of the shoot, ie the exploitation of those rights.

It is important that there is evidence that the business has been commercial in this instance. As a practical planning point it is important to see that every asset owned by landowning clients is reviewed and consideration must be given as to whether APR can still be claimed. If APR is going to be lost due to diversification careful consideration must be given to ensure that BPR can be claimed. When looking at this it is important at the first instance to ensure that there is a business. It is important to look at VAT and case law when considering the element subject to BPR. If APR is applicable the question of whether or not there is a difference between market value and agricultural value must be considered.

Contributed by Julie Butler of Butler & Co

International

135. New UK/US treaty

The United States and the United Kingdom are renegotiating the income treaty they signed on 24 July 2001 and the discussions may focus on the limitations of benefits article.

Although both countries signed the treaty, neither has completed the necessary steps to ratify it. But for the events of 11 September 2001, the US Senate Foreign Relations Committee would probably have held hearings on the UK/US income tax treaty – and other tax treaties – last fall. Until recently, it appeared that the Senate would hold hearings on the treaty this fall.

However, it is now understood that since the treaty was signed a number of issues came to the Revenue's attention that needed further discussion. The new treaty includes a limitations-of-benefits article (LOB) which the treaty currently in force lacks. The US insists that its tax treaties include a LOB article. The new negotiations appear likely to focus on the LOB article.

Contributed by Rajesh Sharma, Partner, Corporate Tax, Smith & Williamson

136. EU Savings Directive

The draft EU Savings Directive is a proposal to introduce an EU-wide measure to combat individual's evading tax on cross-border investments. The idea behind it sounds deceptively simple. This is to identify 'interest' payments made by EU individuals only and then to ensure 'paying agents' report these payments to the domestic tax authority who will pass the information to the individual's home tax authority. The reality of implementing the Directive is considerably more complex. Key issues include:

- What is 'interest'?
- Who is a 'paying agent' and a 'relevant individual'?
- How in practice will paying agents be able to implement the proposals?

The Directive is expected to be effective from 1 January 2004. It will relate to reporting/deduction in the hands of the paying agents paying interest to individuals. The Directive affects payments of interest from one Member State to residents of another Member State.

To be effective countries such as the USA, Switzerland and the Channel Islands will need to sign up, otherwise monies will flow to these countries, effectively making the Directive null and void. Jersey has of course already shown a willingness to agree to the exchange of information powers required by the Directive.

For the UK the first reporting will be at the end of the UK tax year 5 April 2004.

Individuals affected by the Directive are not just 'persons'. It will also relate to 'residual' entities who are not:

a) legal entities;
b) entities taxed under the general arrangements for business taxation; and
c) UCITs or entities who opt to be treated as UCITs. This means that Pension Funds, Charities, Fund Managers, Trusts could be treated as 'individuals' for reporting/deduction. But if the paying agent is paying another paying agent, resident of a Member State, it appears that they can just report the total amount and leave the individual reporting to the second paying agent.

Interest is not just interest on bonds. Other types which could be included are:

a) Interest bearing cash accounts.
b) Sales and redemptions with interest portions. Where the paying agent cannot determine the interest portion the full proceeds will be reported.
c) Distributions by Investment Vehicles where more than 15 per cent of the asset value is interest bearing investments.
d) Sale/redemption proceeds of units in Investment Vehicles where more than 40 per cent of the funds assets are directly in interest bearing securities, 40 per cent will be assumed if not defined. This will reduce to 25 per cent after seven years.

At present there appears to be no penalties for non-compliance, however it would appear that without implementation of a fining regime then the Directive will be unworkable.

The EU is likely to pass the Directive into law by 31 December 2002. Thereafter it will then go to Parliament for adoption by the UK.

Contributed by Francesca Lagerberg, National Tax Director, Smith & Williamson